

CHAPTER 1
THE U.S.-CHINA TRADE
AND ECONOMIC RELATIONSHIP
SECTION 1: TRADE AND ECONOMICS
YEAR IN REVIEW

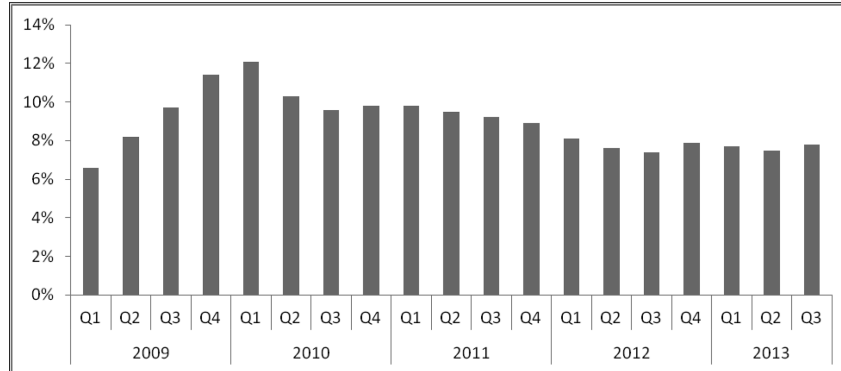
Introduction

China's economy grew at a 7.66 percent annualized rate in the first three quarters of 2013, continuing a three-year trend of decelerating output (see figure 1). This marked a significant decline from the three decades of growth in the 1980s, 1990s, and 2000s averaging 10 percent annually. Demand for China's exports stalled, and the domestic economy adjusted to a drop in government spending on massive infrastructure projects—undermining the two main pillars of China's economic surge over the previous decade.* The slowing of the world's second-largest economy rippled through much of the world, hobbling the economies of commodity-exporting countries. While the economic slowdown matched the central government's stated numerical target for growth, the change was not necessarily the result of a deliberate government policy. Rather, China's growth decline largely stemmed from the effects of a government-induced credit crunch, a precipitous drop in manufacturing, volatility in banking and real estate, a declining rate of growth in household incomes, the strain of meeting interest payments on a growing debt burden, and uncertainty about the new government's direction after a once-a-decade leadership transition. This section will explore the factors behind China's changing economy, the evolution of China's economic policy, and their implications for the United States.

*During the decade that ended with 2011, China's share of global exports rose from 7 percent to 21 percent. James R. Hagerty, "U.S. Manufacturers Gain Ground," *Wall Street Journal*, August 18, 2013. <http://online.wsj.com/article/SB10001424127887323423804579020732661092434.html#printMode>.

Figure 1: China's Quarterly Gross Domestic Product (GDP) Growth, 2009Q1–2013Q3

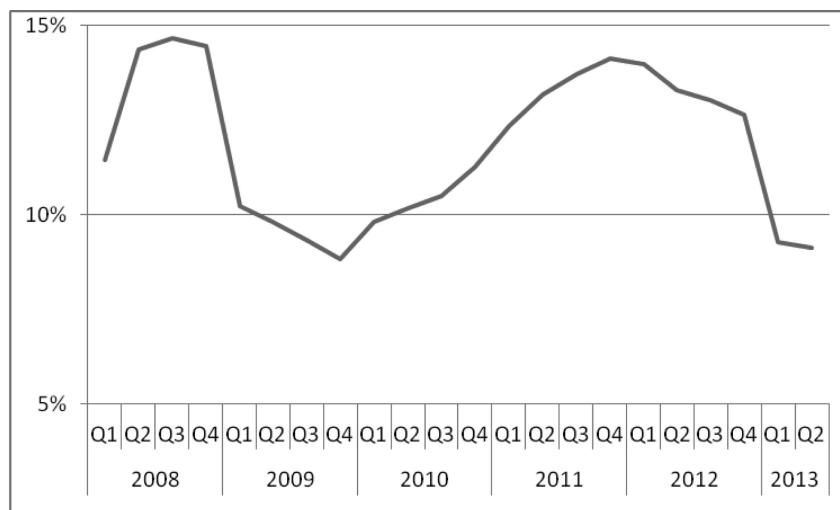
(percent year-on-year growth, real terms)



Source: China National Bureau of Statistics, via Trading Economics. <http://www.tradingeconomics.com/china/gdp-growth-annual>

In order to rebalance the domestic economy, Chinese policy-makers say they intend to raise household income and consumption, but the past year saw limited progress on this front. In urban areas, growth in disposable income, the measure of personal income minus taxes, fell to its lowest levels since the global financial crisis, suggesting that urban wages did not rise at the same rate as in previous years. Urban households, which have very high savings rates, thus had less capacity to raise their consumption expenditure (see figure 2).¹ Growth in Chinese retail sales slowed, and the share of the economy represented by consumer spending declined in the first half of 2013 compared to the same period in 2012. As a share of gross domestic product (GDP), China's domestic consumption remained half that of the United States—following an established pattern.²

Figure 2: Urban Household Disposable Income Growth, 2008–2013Q2
(quarterly, percent year-on-year growth)



Source: China National Bureau of Statistics, via CEIC database.³

In China's repressed financial system, households still deposit the bulk of their savings in low-yielding bank accounts. According to estimates from the investment bank Nomura, China's household debt was only 20 percent of GDP last year, compared to 86 percent in the United States. Still, China's debt burden increased from 121 percent to 155 percent of GDP in 2008–2012—a rapid build-up similar to the United States before the subprime mortgage crisis. Given the explosion of China's shadow banking sector, actual debt levels are likely even higher. Debt is concentrated not among households, but among state-owned industrial enterprises, government-backed property developers, and local governments. The debt-to-asset ratio of property developers, for example, increased from 40 percent to 71 percent in 2009–2012. Unlike the United States, China's households act as net lenders to the rest of the economy, subsidizing the state sector with easy credit.*

Chinese leaders vow to deemphasize exports as a source of income. Export growth in China has slowed as demand in much of the world dropped, though not enough to correct the country's external imbalances. China still sends five dollars' worth of goods to the United States for every dollar in U.S. imports. In 2012, the U.S. deficit with China in goods reached \$315 billion—the highest on record. In July 2013, China's monthly bilateral surplus with the United States surpassed \$30 billion for the first time.⁴ China's vast

* In the United States prior to the subprime mortgage crisis, the overall debt ratio rose by 30 percentage points of GDP, from 214 percent in 2003 to 244 percent in 2007. Zhang Zhiwei and Wendy Chen, "China: Rising Risks of a Financial Crisis" (Hong Kong, China: Nomura International (Hong Kong) Limited, March 15, 2013), pp.4–7; Federal Reserve Bank of St. Louis, "Household Debt to GDP for United States" (St. Louis, Missouri: October 2013). <http://research.stlouisfed.org/fred2/series/HDTGPDUSQ163N>; Tom Orlik, "Debt Binge Threatens China Growth," *Wall Street Journal*, August 27, 2013, p. c1. <http://online.wsj.com/article/SB10001424127887324906304579036592255182758.html>.

current account surplus, coupled with restrictions on its capital accounts and exchange rate, has caused the central bank to accumulate foreign currency reserves exceeding \$3.66 trillion, by far the largest in the world.

Leadership Transition and Economic Policy

In the spring of 2013, Xi Jinping became president of the People's Republic of China (PRC). Li Keqiang, in turn, was appointed the premier and Communist Party secretary of the State Council, China's cabinet. No prominent political or economic reformers were elevated to the Politburo Standing Committee, China's highest decision-making body, though the backgrounds of Wang Qishan and Zhang Gaoli* suggest that they might be open to further economic reform.⁵ Protégés of former PRC President Jiang Zemin captured more spots than the allies of former President Hu Jintao (the sole protégé of Hu Jintao on the Standing Committee is Premier Li Keqiang).† Although Jiang Zemin's era is associated with more economic reform than the subsequent Hu Jintao period, when many reforms were rolled back,‡ there are few signs of a renewed push for reform. (For coverage of the leadership change relating to foreign policy and military matters, please see chap. 2, sec. 1, of this Report.)

The uncertainty over the prospects for economic reform is the result of contradictory statements and actions by the new leadership. On the one hand, there are signs that President Xi and Premier Li are preparing a package of reforms that will be unveiled at the Third Plenary Session of the 18th Central Committee scheduled for November 2013. On the other hand, President Xi has been reaffirming the role of the state in the economy and introducing Maoist-style ideological campaigns aimed at stamping out political liberalization. A Chinese Communist Party (CCP) leadership statement approved by President Xi, "Document No. 9," enumerates seven perils for China, among them, "Western constitutional democracy," human rights, media independence, and market-based "neo-liberalism."⁶ The fundamental conflict is that the economic liberalization the leadership expounds is impossible to achieve if the government continues to expand its ownership of and control over the economy.

Before handing over the reins, President Hu delivered a joint report at the beginning of the 18th Party Congress. Speeches delivered to the Party Congress are considered guides to future policy,

*Zhang Gaoli was appointed the PRC executive vice premier (Wang Qishan was widely expected to be appointed to this position), in charge of economics and domestic policy. Mr. Zhang has extensive leadership experience in economically advanced regions (Shenzhen, Shandong, and Tianjin), but he has kept a low profile, and his views on further reform are unclear.

†For a more detailed assessment of China's new leadership lineup, see John Dotson, *The China Rising Leaders Project, Part 2: Outcomes of the Chinese Communist Party's 18th National Congress* (Washington, DC: U.S.-China Economic and Security Review Commission, December 21, 2012), pp. 19–20. http://origin.www.uscc.gov/sites/default/files/Research/18th-CCP_Party_Congress_Overview.pdf.

‡The state sector has prospered in the past decade, with financing, market access, and various policies aimed at protecting its interests. The consolidation and concentration of economic power in the government's hands has given rise to the catch-phrase "The state advances, the private [sector] retreats." For a detailed discussion of the Chinese government's role in and control over the Chinese economy, see U.S.-China Economic and Security Review Commission, *2012 Report to Congress* (Washington, DC: U.S. Government Printing Office, November 2012), pp. 47–72.

especially during a power transition, because they are drafted by both incoming and outgoing leaders. The outgoing president's speech was interpreted by many analysts as a blow to economic reform. For example, the report contained strong language on the need to strengthen the state-owned portion of the economy. The departing President Hu said China would "unwaveringly consolidate and develop public ownership" and "steadily enhance the vitality of the state-owned sector of the economy and its capacity to leverage and influence the economy."⁷ The report proclaimed that state-owned enterprises (SOEs) are the principal part of the Chinese economy and that they will increase their investment in areas of the economy that impact national security and core national interests.

Six months earlier, Mr. Xi had made his first trip as leader to the southern Chinese city of Shenzhen, in a gesture interpreted as more reformist, because it paralleled a similar trip by Deng Xiaoping during his famous "southern tour" to the same area 20 years ago.* President Xi followed up with trips to the countryside to highlight the plight of the rural poor.

Premier Li, who is broadly responsible for formulating and implementing economic and domestic policy, gave an early speech at a meeting of representatives of the 11 national "Comprehensive Reform Pilot Areas," which was interpreted by some western analysts as signaling his commitment to economic reform.⁸ In particular, the speech started off noting that "reform is like a boat beating against the current; if you don't move forward, you will slip backwards." At the March 2013 annual Party Congress, Premier Li gave his first news conference. He pointed to the need to "shake up vested interests," stating that "however deep the water may be, we will wade into the water."⁹ The government would have to enact a "self-imposed revolution," which would be "very painful and even feel like cutting one's wrist."¹⁰ The reformist tone aside, Premier Li has loyally supported former President Hu's policies, which have hindered or reversed economic reform.

The New Economic Leadership Team

The National People's Congress meeting in March 2013 revealed the makeup of the economic leadership team that will be in charge of crafting economic policy for China's new administration. The lineup appears encouraging for economic reform; however, these individuals, though involved in policy-making, are not on the Standing Committee and, therefore, do not set the direction of China's economic policy. Much will depend on whether these individuals will be willing and able to sway the leadership toward economic reforms. Three top decisionmakers are highlighted below.

*During his 1992 southern tour, Deng Xiaoping stressed the importance of continuing economic reforms launched in 1978 and criticized those who were against further economic and openness reforms.

The New Economic Leadership Team—Continued

Zhou Xiaochuan was asked to stay on as head of the People's Bank of China (PBOC), the central bank. Observers were surprised by the announcement that Mr. Zhou will remain in his position since he turned 65 in January 2013, the ordinary retirement age for a minister-level official. According to insiders, the move is aimed at ensuring continuity in financial-sector policy-making and signals a desire to stay on course with the kind of financial reforms Mr. Zhou has championed, including a more flexible renminbi (RMB) exchange rate and market-based interest rate system.¹¹

Lou Jiwei was appointed minister of finance. Mr. Lou, best known abroad as the former head of China's most public sovereign wealth fund, the China Investment Corporation (CIC), was a deputy finance minister for ten years and is known for his support of financial liberalization.¹² His comments at the 2013 Strategic and Economic Dialogue (S&ED) talks in Washington generated some controversy when Xinhua, the official CCP propaganda arm and news agency, censored his remarks regarding China's target GDP growth in 2013. Mr. Lou said, "There is no doubt that China can achieve the growth target, though the 7 percent goal should not be considered as the bottom line," but Xinhua changed that to "7.5 percent" (the official target) in its reporting.¹³

Liu He, long recognized as the key economic adviser to Xi Jinping, was confirmed as the official head of the Leading Group for Financial and Economic Affairs of the CCP Central Committee.¹⁴ Mr. Liu will also hold an appointment as a vice head of the National Development and Reform Commission (NDRC), China's chief economic planning body. As the head of the Leading Group for Financial and Economic Affairs, Mr. Liu will lead the writing of the official documents framing economic reforms planned over the next five years.¹⁵ According to Cheng Li, a China scholar at The Brookings Institution, Mr. Liu was a "major collaborator" in last year's World Bank report¹⁶ that advocated accelerating market-driven change and is a proponent of financial liberalization.¹⁷

Economic policymakers have identified and registered some limited successes in addressing problems that threaten to foment unrest among Chinese citizens who are not part of the urban coastal elite. In recent months, the government has introduced some important initiatives aimed at addressing some of the country's growing inequalities of wealth and opportunity.

Inequality: Even as President Xi and Premier Li's rhetoric indicates a reformist bent, resistance to reform from entrenched local interests and the export sector remains strong.¹⁸ Although the Chinese government has been successful in lifting millions out of poverty, China's level of inequality has been steadily rising. In February 2013, the State Council released a new plan aimed at curbing inequality and redressing some of the worst gaps in develop-

ment between urban and rural populations.* The plan includes an ambitious agenda for expanding the social safety net, improving healthcare and education, limiting the power of SOEs, and tackling corruption by government officials.

The 35-point “Income Distribution Plan” is aimed at boosting minimum wages to at least 40 percent of average salaries, loosening controls on bank lending and deposit rates, and increasing spending on education and affordable housing.¹⁹ Other reforms include a requirement that SOEs contribute more of their profits to the effort of reducing inequality and a commitment to push through market-oriented interest rate reforms to give savers a better return and more security. In theory, these measures signal an attempt to shift the economy toward increased domestic consumption as an underpinning for economic growth. As with most sweeping Chinese government plans, everything depends on implementation. For example, past proposals to encourage higher dividend payments from SOEs collapsed under fierce resistance from the politically powerful heads of the SOEs, who are also ranking Communist Party members. Similarly, corruption is endemic among local government officials, and addressing its manifestations, such as land seizures from peasant farmers, might undermine the stability of the CCP (see below).

Corruption: A Pew Research Center poll last year showed a rise between 2008 and 2012 in Chinese public concern about corrupt officials. The anticorruption group Transparency International last year ranked China number 80 out of 174 countries in terms of perceptions of corruption in the public sector, worse than Liberia, Italy, and South Africa. Transparency International excluded China from its 2013 survey on corruption because local polling survey firms, which are licensed by the government, said they would have to omit certain questions in order to be allowed to conduct the survey.²⁰

Upon becoming president last November, Mr. Xi vowed to eliminate the “tigers and flies” (i.e., high-ranking as well as low-ranking officials) who had enriched themselves through bribery and patronage. He denounced the prevalence of corruption and said officials needed to guard against its spread, or it would “doom the Party and the state.”²¹ Some observers took Wang Qishan’s assignment as the director of the CCP’s watchdog agency for corruption, the Central Disciplinary Inspection Commission, as a sign of the government’s seriousness about the issue. Mr. Wang’s previous experience in banking and international trade might have made him a better fit in an economic position, but reformers applauded Mr. Wang’s choice because he has a strong reputation as a “firefighter” and capable problem solver.²²

In the past, the Chinese government has paid lip service to tackling corruption without undertaking any actual reform. The current anticorruption campaign appears similarly aimed at placating the public anger or eliminating political enemies rather than creating genuine change. For example, the focus on Chinese officials and ex-

*For an in-depth analysis of the new reform plan, see Nargiza Salidjanova, *China’s New Income Inequality Reform Plan and Implications for Rebalancing* (Washington, DC: U.S.-China Economic and Security Review Commission, March 12, 2013). <http://origin.www.uscc.gov/sites/default/files/Research/China%20Inequality%20-%203%2012%2013.pdf>.

ecutives at China's big, state-run companies appears to be politically motivated.²³ The head of the State-owned Assets Supervision and Administration Commission, the agency responsible for supervising state-owned assets, was recently removed for "serious disciplinary violations." He is a close associate of Zhou Yongkang, former domestic security chief, who is also targeted in the current campaign.²⁴ Four senior managers at PetroChina have been removed amid separate investigations by authorities; one of the executives is a former aide to Mr. Zhou.²⁵

President Xi has spearheaded an austerity drive, banning banquets, gift-giving, and other lavish trappings of Chinese officialdom. There are signs that this is having a real impact: First-class airline ticket sales have dropped by a tenth in recent months; luxury goods dealers have reported a 20 percent to 30 percent decrease in sales; and restaurants surveyed in February experienced a 60 percent drop in reservations over the same period in 2012.²⁶

The Chinese government also issued a directive banning the construction of government buildings for the next five years. The new directive is a continuation of the anticorruption campaign, describing the ban as "important for building a clean government" and improving the ties between the party and the people.²⁷ Grandiose official galas, which often feature variety shows and celebrity appearances, are likewise banned, because they are "wasteful" and had "damaged the image of the Chinese Communist Party and the government, triggering public complaints."²⁸

The affected local governments are finding ways to side-step these bans. According to a report in Xinhua, local government officials in some provinces are reclassifying government buildings in order to avoid notice. For example, in Jiangsu Province, the government power company offices have been renamed "dispatch centers," and public security offices have been renamed "technical investigation centers."²⁹ Furthermore, the construction ban does not address the proliferation of so-called "luxurious canteens," or deluxe cafeterias in government offices.

While the anticorruption efforts have appeared in the headlines, the reality presents a more confusing picture. For example, a proposed regulation that would require top officials to publicly disclose their personal assets has stalled.³⁰ Moreover, just as the prohibition on new government buildings was being announced, the government started to round up and prosecute activists who called on officials to disclose their wealth and the wealth of their families. In the most celebrated case, Xu Zhiyong, a prominent human rights activist, was charged with "assembling a crowd to disrupt order in a public place."³¹

Despite official proclamations, so far the CCP has demonstrated "little inclination" to pursue any fundamental reforms to root out corruption, according to Elizabeth Economy, director for Asia Studies at the Council on Foreign Relations. Instead, the latest measures will most likely follow an established pattern: "a number of high-profile arrests, no institutional change [...], and an endless cycle of anticorruption campaigns."³² According to Minxin Pei, professor of political science at Claremont McKenna University, President Xi does not actually want to end corruption, because it is the lifeblood of the Chinese government: "The Communist Party is a

patronage machine and patronage by definition is corruption.”³³ In other words, while fighting corruption might endanger the party, cracking down on the appearance of corruption is a good measure to address the “public relations nightmare that accompanies corruption.”³⁴ Party officials remain staunchly opposed to disclosing their assets, and both *The New York Times* and Bloomberg websites were blocked in China after reporting on the wealth amassed by the families of former Premier Wen Jiabao and Xi Jinping, respectively.

Urbanization: Premier Li has made urbanization the core of his agenda, calling it “the biggest development potential.”³⁵ Government departments are drawing up policies to guide rural citizens into cities over the next decade.³⁶ The hope is that urbanization will become the next growth engine, initiating a new wave of investment, adding to the consumer class, and creating a surge in demand for housing and infrastructure.³⁷ The urbanization drive may also boost Chinese efforts to make more land available for agriculture and improve farming efficiency (for more on the government’s agriculture modernization efforts, see chap. 1, sec. 4, of this Report).

The effect is likely exaggerated. For example, in many cases urbanization will simply entail the reclassification of rural areas as urban and not boost consumption or investment.³⁸ In addition, unscrupulous officials might use the excuse of urbanization to seize village land, which they then may sell to developers without compensating the farmers.

The key test of the Chinese government’s ability to push through greater urbanization will be how it plans to pay for it. The Chinese Academy of Social Sciences, a government think tank, estimates the cost (including spending on healthcare, housing, and schools) at \$106 billion a year, the equivalent of 5.5 percent of fiscal revenue in 2012.³⁹ Local governments cannot pick up the check for the expansion of such costly spending since they do not have a steady tax revenue stream: By law they must give most tax receipts to the central government. As a result, most local governments rely on land seizures and sales to fund spending, already a large contributor to public perceptions of corruption since farmers receive comparatively little from the government,

No urbanization initiative can be fully successful without first tackling one of the key factors behind the rural-urban disparity: China’s system of household registration, known as *hukou*.^{*} People from the countryside with a rural registration, or *hukou*, are restricted from enjoying the far better education and health benefits available to those with an urban *hukou*. Allowing migrants to the cities to obtain an urban *hukou* has been met with strong resist-

^{*} Created in its current form in 1960, China’s modern *hukou* was first developed after 20 million migrants rushed to China’s urban cities during the Great Leap Forward (1958–1960) in order to fill a perceived labor gap. The *hukou* system requires the registration of all citizens in China at birth and then limits access to government services based on the residency permits issued after registration. Citizens’ residency permits fall into one of two categories, urban or rural *hukou*, and entitle a holder access to social services in the town or city to which their *hukou* is registered. For more on the *hukou* registration and its impact on migrant workers, see “China’s Internal Dilemmas” in U.S.-China Economic and Security Review Commission, *2011 Report to Congress* (Washington, DC: U.S. Government Printing Office, November 2011), pp. 107–128. www.uscc.gov/Annual_Reports.

ance from local governments that fear being overwhelmed by a flood of new migrants.⁴⁰ There are small signs of change. A report issued by the State Council suggests that the government is considering relaxing *hukou* in small cities “in an orderly manner” in tandem with the urbanization drive, to be followed by bigger cities.⁴¹

The Mini Stimulus

In July 2013, the Chinese government announced a package of measures aimed at boosting the slowing economy while at the same time staying away from the massive investment drive. It also appears aimed primarily at small- and medium-sized private enterprises rather than SOEs, which were the main beneficiaries of the 2008 stimulus package. A statement by the State Council described a three-pronged approach: a temporary tax cut (scrapping all value-added and operating taxes) for more than six million small- and medium-sized enterprises; reduction of approval procedures and administrative costs for exporting companies; and more investment in railway construction in China’s central and western regions.⁴²

In recent decades, the CCP has derived its legitimacy from growth, so the government’s willingness to tolerate slow growth may be finite, particularly if unemployment rates rise. A major test for China will be how the rest of the global economy performs. Many analysts believe the top priority for the new leadership is not reform but making sure that growth does not deviate far from the official 7.5 percent target. If the economies of China’s biggest trading partners, the United States, the European Union (EU), and Japan, remain weak, the pressure on the Chinese economy may force the new government to return to such policies as further credit expansion or infrastructure investment, which shore up growth in the short term but also create more problems in the future, such as inflation, overcapacity, excessive debt, and economic uncertainty.

Rebalancing China’s Economy

Economic rebalancing is a multifaceted challenge for China that not only entails lowering investment and increasing overall consumption but also scaling down the role of the state sector, reducing speculative investment in real estate, altering the way credit is allocated, and speeding growth of the services sector. Some economists predict that effective rebalancing of China’s economy will result in more sustainable long-term growth.⁴³ Failure to make necessary reforms to rebalance China’s economy may result in reduced output, widespread defaults, stress on the banking sector, and social unrest.⁴⁴ But in the past year, China has made little progress toward its stated goal and, in some cases, has regressed to the old, short-term solutions: ramping up exports through subsidies to exporters and borrowing to undertake infrastructure projects and increase factory output.

Although China marginally reduced its massive trade surplus in the years immediately following the 2007–2008 global financial cri-

sis, this progress was temporary and largely attributed to domestic stimulus and slowing demand in western economies. Rebalancing China's domestic economy has lagged even more so, as some positive trends proved to be short-lived.

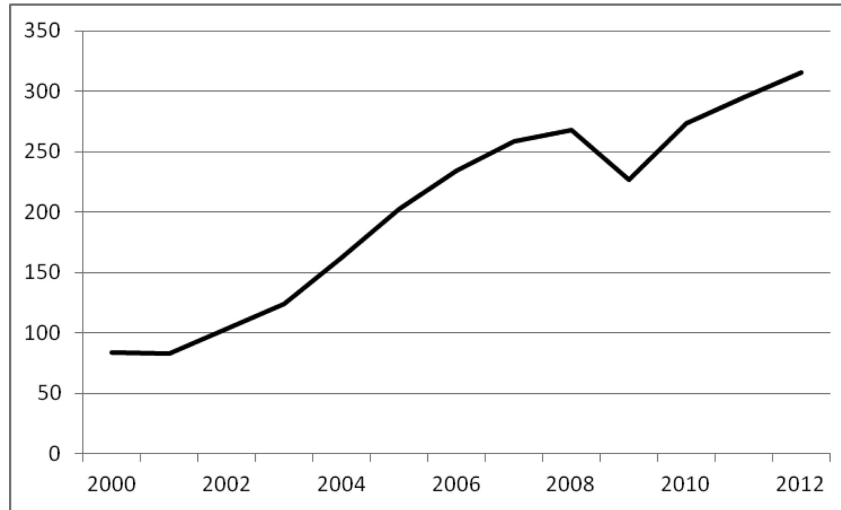
There are good reasons for the Chinese government not to try to boost growth with additional stimulus or policies to expand exports: A GDP slowdown may help Beijing tackle some of the structural problems with the economy, once described by former Premier Wen Jiabao as "unbalanced, uncoordinated, and unsustainable." Patrick Chovanec, an economist who has written extensively about the Chinese economy, says that "if China slowed for the right reasons, by being more selective with their investments, and moving toward more consumption, a slight slowdown would actually be a good thing."⁴⁵ Proper economic rebalancing, however, cannot happen without a significant decrease in medium-term growth rates, and the government's willingness to tolerate slow growth on a sustained basis is untested.

External Rebalancing

Balancing China's external accounts with other nations—or reducing China's massive trade surplus by increasing the import share of total trade—is a key element in rebalancing China's economy. Following the global financial crisis, China made progress in reducing its global trade surplus, which fell as a share of GDP from a peak of 10 percent in 2007 to 2.7 percent in the first half of 2013.⁴⁶ However, the decline in China's trade surplus with the world is not necessarily an outcome of deliberate structural rebalancing. In the first half of 2013, China's goods exports outpaced goods imports by 4 percentage points, causing its trade surplus with the world to grow by 40 percent year-on-year to \$157 billion.⁴⁷ The International Monetary Fund (IMF) projects that China's current account surplus will rise from 2.7 percent to 4 percent of GDP by 2018. This forecast assumes that there will be a gradual recovery in global demand, minimal appreciation of the RMB, and limited progress in domestic rebalancing.⁴⁸

The United States is among the countries most affected by China's export surplus (see figure 3). The U.S. cumulative bilateral deficit with China has risen to more than \$3 trillion since 1979.⁴⁹ For the first six months of 2013, China's goods trade surplus with the United States was \$148 billion; a decade ago, that figure stood at \$54 billion. While China sold 17 percent of its total goods exports to the United States in 2012, it purchased just 7 percent of total U.S. exports.⁵⁰ More strikingly, China in 2012 was responsible for nearly three-quarters of the U.S. trade deficit in non-oil products.⁵¹

Figure 3: U.S.-China Trade Deficit in Goods, 2000–2012
(US\$ billions)



Source: U.S. Bureau of Economic Analysis.

To be sure, U.S. manufactures exports to the world improved slightly in the first half of 2013, registering a lower deficit than in the prior year. Some industry experts have interpreted this as a sign of rising competitiveness in U.S. industry, driven in part by low energy prices.⁵² Nevertheless, the only manufacturing sector in which the United States registered a substantial trade surplus with China was transportation equipment (\$3.6 billion), which comprises automotive, aircraft, and ship products. Other sectors with a substantial surplus were agriculture (\$6.3 billion), waste and scrap (\$4.2 billion), and minerals and ores (\$1.3 billion). The United States has a persistent trade deficit with China in advanced technology products. Although exports to China have improved in the first half of 2013, the total value of trade in those sectors is small (see table 1).

Table 1: U.S. Trade Balance with China in Advanced Technology Products, January-June, 2012–2013
(U.S. millions)

	Ex-ports	Im-ports	YTD Balance Jun'13	YTD Balance Jun'12	Change 2012–2013
TOTAL	7,828	42,327	-34,499	-35,418	919
(01) Biotechnology	122	25	97	58	39
(02) Life Science	901	667	234	156	78
(03) Optoelectronics	102	1,335	-1,233	-2,429	1,196
(04) Information & Communications	1,375	38,607	-37,232	-35,717	(1,515)
(05) Electronics	1,439	1,049	390	163	227
(06) Flexible Manufacturing	713	278	435	185	250
(07) Advanced Materials	77	70	7	15	(8)

Table 1: U.S. Trade Balance with China in Advanced Technology Products, January-June, 2012-2013—Continued
(U.S. millions)

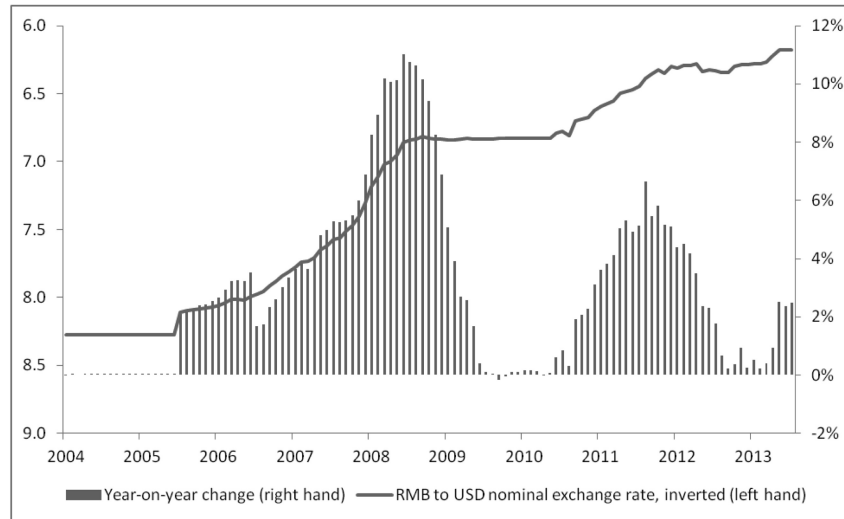
	Ex-ports	Im-ports	YTD Balance Jun'13	YTD Balance Jun'12	Change 2012-2013
(08) Aerospace	2,901	256	2,645	2,162	483
(09) Weapons	1	39	-38	-34	(4)
(10) Nuclear Technology	199	1	198	23	175

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

There are four important preconditions for increasing China's imports as a share of total trade. First, China must further open its market to imports in order to allow increased competition to stimulate consumption. At the China Development Forum held in March, Premier Li acknowledged as much, promising that "China will expand its opening-up policy, and the nation needs to promote domestic consumption through continuing to open up its markets."⁵³ Second, the RMB must continue to appreciate against the dollar, to lower the price of U.S. goods and services in China. Third, household disposable income must continue to grow to create sufficient domestic demand. Fourth, China must reduce its household and corporate savings rate. Money that is not saved or invested is necessarily spent, often on imports. In 2012, however, China's private savings rate reached the world's highest level, surpassing 50 percent, well above the global average of 20 percent. The high savings rate is largely attributed to China's low level of government safety net spending on health, education, and old age pensions, high down payment requirements for securing mortgages, negative or low real interest rates on ordinary bank deposits, and capital controls that restrict Chinese citizens from investing abroad.⁵⁴

RMB Revaluation

The RMB has continued to slowly appreciate against the dollar, gaining less than 2 percent in the first half of 2013.⁵⁵ This represents a slowdown in appreciation from previous years, particularly when compared to the period 2005–2008 (see figure 4). The rise of the RMB is still not controlled by market forces; the PBOC resets the value of the currency at the start of each trading day, allowing only 1 percent daily fluctuation. In January, strong market pressures to appreciate the currency were offset by interventions in the international currency market by the central bank and China's state-owned commercial banks, which purchased a record \$110 billion worth of foreign exchange within a matter of days.⁵⁶

Figure 4: Appreciation of the RMB, 2004–2013H1

Note: “2013H1” includes data from January to June 2013.

Source: China State Administration of Foreign Exchange, via CEIC database.

The Commission in past years has characterized the value of the RMB as “manipulated” by the Chinese central bank in an effort by the government to discount its exports to the United States and raise the price of U.S. exports to China. The intended purpose is to create and maintain an artificially high surplus in China’s bilateral trade with the United States. The U.S. Treasury Department chooses not to use this technical term in order to avoid mandatory countermeasures dictated by U.S. law* but acknowledges that China’s exchange rate “continues to be tightly managed” and “continues to exhibit significant undervaluation.”⁵⁷

As in previous administrations, the U.S. Treasury Department has taken up the issue with China during bilateral talks and received assurances from top Chinese officials that change will be forthcoming and that market forces will be allowed a “bigger role” in determining the value of the RMB. However, China still refuses to publish data on exchange rate interventions by the central bank, in contrast to other G-20 members. Such interventions, combined with China’s subsidies to exporting industries, have helped China accumulate the world’s largest foreign currency reserves—\$3.66 trillion by the end of September 2013—almost as large as the total amount of foreign exchange reserves held by all advanced economies combined.⁵⁸ The monthly U.S. trade deficit in goods with China hit a record \$30.1 billion in July.⁵⁹

*The U.S. Treasury Department is required by the Trade Act of 1988 to report to Congress twice yearly on the exchange rate policies of major trading partners and to identify countries that “manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade.” The Administration would be required to open negotiations with any country so designated.

Further Developments in RMB Internationalization

As part of a push to internationalize the RMB, China has been developing an offshore market for it as a precursor to allowing global firms, banks, and asset managers access to its domestic market. China has currency swap lines* with around 20 countries, mostly small, emerging economies that have natural resources, such as Argentina and Indonesia, but no major economic powers like the United States or EU countries. That may be about to change as China established two important swap agreements with major trade partners. First, the Bank of England, Britain's central bank, and the PBOC established a currency swap line in June 2013. The agreement will initially last for three years and has a maximum value of 200 billion RMB (\$32.6 billion).⁶⁰ Then, in October 2013, China agreed to swap euros and RMB with the European Central Bank, China's second largest swap deal. The swap agreement has a maximum size of RMB 350 billion (\$60.8 billion) and is valid for three years.⁶¹

In January 2013, Taiwan and China formally established a direct RMB-clearing system between them, following a signing of a cross-strait currency clearing last year. Taiwan will become the third place with such a clearing arrangement with China, after Hong Kong and Macau. Under the agreement, Taiwan's and China's central banks will be able to settle directly in RMB payments without first converting their currencies into U.S. dollars, which is the current practice.⁶²

On April 25, 2013, the government in Hong Kong loosened restrictions on interbank trading of the RMB, a move that is intended to enhance Hong Kong's status as an offshore RMB trading center, a segment that is witnessing competition from other financial centers.⁶³ Global use of the RMB for trade settlement is limited but has been rising steadily. By June 2013, the volume of RMB used to settle trade was 174 percent higher than in January 2012, when the policy was first introduced.⁶⁴ The Chinese currency now ranks 13th in the world for cross-border payments, up from 20th this time last year, according to SWIFT, the global payments company.⁶⁵ True RMB internationalization stays out of reach, however, as long as China's capital account remains closed, which makes use of RMB for trade settlement and investment difficult.

Domestic Rebalancing

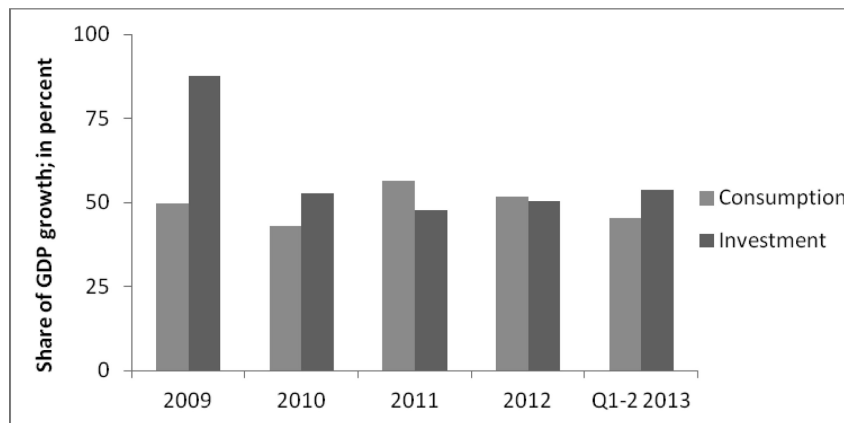
As of 2013, imbalances in China's domestic economy remain substantial. Beijing's economic policy has resulted in what the IMF calls a "pattern of growth [that] has become too reliant on investment and an unsustainable surge in credit, resulting in rising domestic vulnerabilities."⁶⁶ Rebalancing toward consumption-driven growth can only be achieved if consumption continually grows faster than investment for many years. Yet while private and govern-

*Under a swap agreement, central banks agree to exchange each other's currency and can then lend the money to domestic banks to improve liquidity.

ment consumption accounted for more than half of China's GDP growth in 2011–12, the trend reversed in the first half of 2013.⁶⁷ Nicholas Borst of the Peterson Institute for International Economics rated China's progress in rebalancing a grade of "D" and "F" for the first and second quarters of 2013, respectively.⁶⁸ His perspective summed up the consensus that China has experienced no significant domestic rebalancing this year.

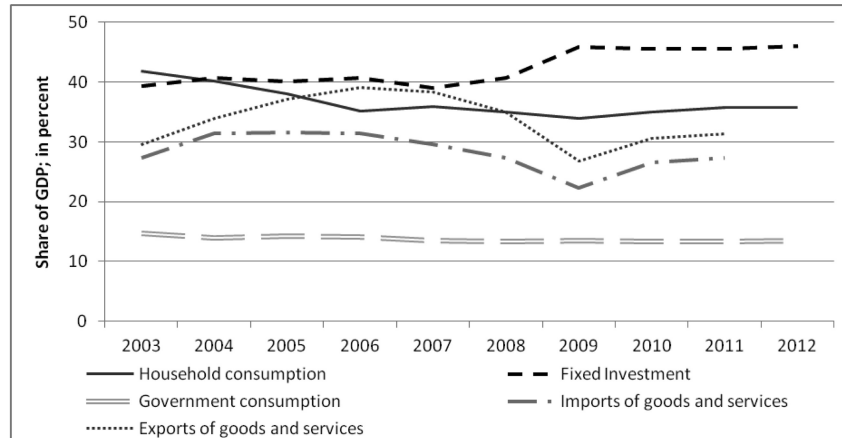
In the first half of 2013, consumption's contribution to economic growth fell below investment for the first time since 2010. Consumption contributed 45.2 percent to GDP growth, down 15.4 percentage points from the first half of 2012. Investment, however, increased to 53.9 percent, up 2.7 percent from 2012 (see figure 5).⁶⁹ In China, consumption's share of GDP remains low compared to other countries. Globally, it represents about 65 percent of GDP, and China's share of consumption is still far lower than developed western economies, where consumption accounts for over 70 percent of GDP (see figure 6).⁷⁰

Figure 5: China's Consumption vs. Investment, 2009–2013
(as share of GDP growth; in percent)



Source: China National Bureau of Statistics, via CEIC database.

The IMF has warned that if credit-fuelled investment in the manufacturing sector remains high, resources are likely to be wasted and nonperforming assets will accumulate, because such investment will only add to China's industrial overcapacity.⁷¹ Numerous examples of overinvestment and excess supply resulting in overcapacity have already arisen in the steel, shipbuilding, and solar manufacturing industries, which has resulted in insolvency and employee layoffs for many companies.⁷² This slowdown in the manufacturing sector has resulted in diminishing returns on the government's investment. Beijing has expressed tolerance for slower economic growth while it claims to be directing China's economy toward more domestic consumption.⁷³ Despite this, independent analysts believe that China's new leaders lack the political will to adopt an ambitious rebalancing agenda.⁷⁴

Figure 6: Composition of China's GDP, 2000–2012

Note: 2012 data for “imports of goods and services” and “exports of goods and services” were not yet released by the World Bank at the time of publication.

Source: World Bank China data (Washington, DC: 2013). <http://data.worldbank.org/country/china>.

The most important—and most challenging—element of domestic rebalancing is increasing household consumption as a share of GDP.* Households’ consumption has declined as a share of China’s GDP for decades while the share of fixed-asset investment has grown. Although year-on-year growth of urban household consumption has been expanding at a steady rate of 9.7 percent for the past ten years, in the first half of 2013, growth in urban household consumption dropped to 7.2 percent.⁷⁵ Meanwhile, fixed-asset investment grew by 20 percent.⁷⁶ Although for the past decade real annual growth of household consumption in China has outperformed a dozen major economies, including Brazil and India,[†] as long as fixed-asset investment is growing faster than household consumption, it will be difficult to rebalance China’s domestic economy.

An important factor in increasing household consumption’s share of GDP is sustained growth in disposable income minus any increase in the household savings rate.⁷⁷ If disposable income grows and the household savings rate remains stable or declines, this will result in more spending by Chinese consumers—a positive sign for domestic rebalancing. In the first half of 2013, however, the opposite occurred. Growth in nominal median urban household income took a dive, declining by 5.8 percentage points. The urban household savings rate remained high, reaching 35.6 percent, up 1.1 percent from 2012. And, most notably, there was lower growth of real

*Household consumption is generally defined as expenditures for goods and services by a household, excluding the purchase of a home but adjusting for “imputed rent” or the amount that a household would pay to rent the same residence. It includes healthcare and education—even that portion supplied by the government—but does not include taxes paid to government nor does it include savings or investments by the household.

[†]According to Daniel H. Rosen and Beibei Bao of the Rhodium Group, it is unreasonable to expect household consumption to grow faster than its current rate. They argue that effective rebalancing will not depend on a growth in household consumption but on reduced and better managed investment growth. Daniel H. Rosen and Beibei Bao, “China Has Problems, But Household Consumption Isn’t One,” *Caixin*, September 20, 2013. <http://english.caixin.com/2013-09-20/100584374.html>.

urban disposable income.⁷⁸ These three factors—slowing income growth, an increasing household savings rate, and a drop in growth of urban disposable income—cut into overall household consumption. In turn, the slowdown in household consumption contributed to an overall slowdown in retail sales. Year-on-year growth in retail sales for the first half of 2013 was down to 12.7 percent from 14.4 percent in 2012.⁷⁹ On a quarterly basis, growth in retail sales was down an average 1.3 percent from last year.*

Financial reform is also integral to rebalancing China's economy. Continued reform in China's banking system is a precondition to increasing access to credit and providing higher returns on household deposits. The new leadership made progress toward financial reform in July 2013 when the PBOC announced it would eliminate the floor on lending rates, allowing banks more freedom to compete by offering cheaper loans.⁸⁰ As a result, loans may become more accessible to small- and medium-sized enterprises. Although removing the floor on lending rates is a major step in financial reform, the PBOC did not remove the more important ceiling on deposit rates. The ceiling limits the rate that banks can pay depositors and ultimately stymies growth in household disposable income.⁸¹ The PBOC acknowledged that removing curbs on deposit rates would have a greater effect on consumption than lending rate reform.⁸²

Maintaining positive real interest rates would also play a role in increasing the returns for China's households. Interest rates on one-year deposits lagged behind inflation and were thus negative from 2010 to 2011, which adversely affected household consumption by cutting into disposable income. Depositors find that their savings have less purchasing power over time when inflation exceeds their return on savings. Although real interest rates have been positive since peaking at 1.5 percent in June 2012, they dropped to 0.3 percent in 2013.⁸³ As a result of the low interest rates, many seeking higher returns will favor alternatives in China's property sector, a cycle that will only result in increased fixed-asset investment and further inflation of China's real estate bubble.

China implemented a new set of controls in March 2013 on the housing market that were targeted at curbing speculative investment in real estate.⁸⁴ However, growth of investment in residential real estate continues to exceed real GDP growth, and reports of excess housing stock have indicated that it is unlikely that real estate investment is driven by actual demand.⁸⁵

Monetary Policy

Management of Foreign Exchange Reserves

The reserve assets held by China's central bank grew by \$169 billion in the first half of 2013—\$37 billion more than in all of 2012.† Although China's reserve accumulation has slowed significantly since 2011, cumulative reserves are still extremely large, exceeding the combined foreign holdings of Japan, Norway, the

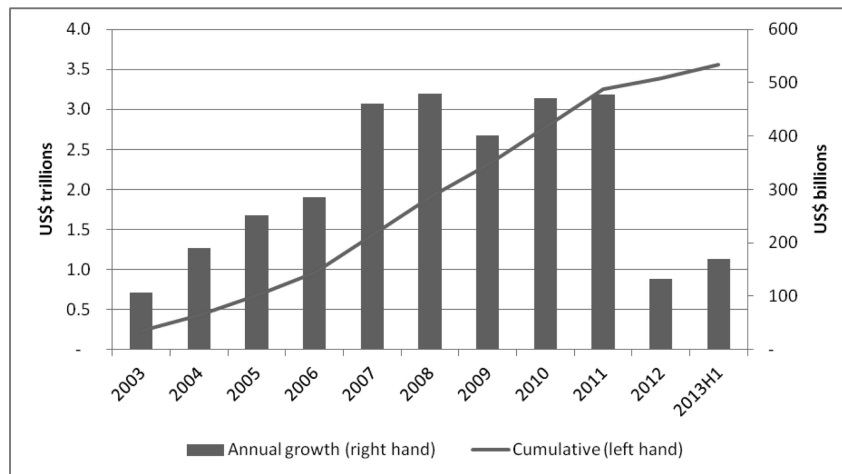
*Data used in calculation exclude the months of January and February. China National Bureau of Statistics, via CEIC database.

†Total "reserve assets" are primarily comprised of foreign exchange. By the end of September 2013, China's foreign exchange reserves reached \$3.66 trillion.

United Arab Emirates, and Saudi Arabia, which rank directly behind China as the top foreign exchange reserve holders (see figure 7).⁸⁶

China's share of U.S. Treasuries in foreign hands increased to 23.2 percent in 2013, cementing its rank as the world's largest holder of U.S. Treasury securities. Other top holders of U.S. Treasuries, such as Japan, Brazil, and Taiwan, all saw their shares decrease over this period.⁸⁷ As of June 2012 (most recent data), China was also the second-largest holder of U.S. agency debt, at \$202 billion.

Figure 7: Growth of China's Reserve Assets, 2003–2013
Cumulative (US\$ trillions); Annual (US\$ billions)



Note: "2013H1" refers to first half of 2013. Numbers for 2003 to 2010 are from China State Administration of Foreign Exchange's balance of payments data. Numbers for 2011 to 2013 are from the State Administration of Foreign Exchange's quarterly report on the international investment position, which are more widely used by economists but are not available for the period before 2011.

Source: China State Administration of Foreign Exchange, via CEIC database.

While maintaining a preference for government securities, China continues to diversify its foreign exchange assets. China's non-financial outbound foreign direct investment (FDI) for the first half of 2013 totaled \$45.6 billion, up 29 percent from the prior year.⁸⁸ One motive behind China's outbound FDI is to acquire resources and enter new markets overseas. In this context, China is increasing its direct ownership of foreign companies. Another motive, which also relates to China's portfolio investments and overseas loans, is to counteract the depreciation of the dollar against the RMB and to earn a higher yield than is provided by U.S. Treasuries.⁸⁹ (For an analysis of China's foreign investment in the United States, see chap. 1, sec. 2, of this Report.)

Rising Competition among China's Sovereign Wealth Funds

China Investment Corp. (CIC),* established in 2007, is the only state-sponsored investment vehicle recognized by the Chinese government as a sovereign wealth fund. But, according to the Sovereign Wealth Fund Institute, an international research body, mainland China currently has three other entities that may qualify as sovereign wealth funds—State Administration of Foreign Exchange (SAFE) Investment Company,† the National Social Security Fund,‡ and the China-Africa Development Fund.§ Each investment fund serves separate interests among branches of the Chinese government and competes with other state-sponsored entities for access to China's foreign exchange reserves.

The Ministry of Finance has been the strongest supporter of CIC and has advocated that the fund act as China's primary outbound investor.⁹⁰ Lou Jiwei, formerly the vice minister of Finance, served as CIC's chairman in 2007–2013.⁹¹ As part of the leadership transition, he was appointed as minister of finance in March 2013.⁹² After some bureaucratic infighting, Mr. Lou was replaced at CIC by another Ministry of Finance official, effectively allowing the ministry to retain its influence over the fund.⁹³ China's central bank, on the other hand, has preferred to invest the country's dollar reserves through other state-sponsored investors. SAFE, the subsidiary of the central bank that manages the bank's foreign exchange, is subject to less external pressure than CIC, because it does not participate in internationally recommended practices on transparency.¶

*CIC is registered as a state-owned enterprise under China's Company Law. Unlike SAFE Investment Company and the National Social Security Fund, it is not a legal subsidiary of any government agency. It reports like a ministry directly to the State Council, China's highest administrative body. Under CIC's Articles of Association, five government agencies—the People's Bank of China, SAFE, the Ministry of Finance, the Ministry of Commerce, and the National Development and Reform Commission—have a seat on the fund's board.

†SAFE Investment Company is a limited company that was registered in Hong Kong prior to the handover of the island to mainland China. It constitutes one of four overseas investment arms of the State Administration of Foreign Exchange. The State Administration of Foreign Exchange is the branch of the People's Bank of China, China's central bank, which exclusively manages China's foreign exchange reserves. SAFE Investment Company's primary objective is to retain the value of China's foreign exchange by making portfolio investments overseas.

‡Established by the State Council, under the auspices of the Ministry of Social Security, the National Social Security Fund is a public pension fund under China's Social Insurance Law. Its objective is to maintain the real value of public pension proceeds as a means to support future social security expenditures. The National Social Security Fund can invest 20 percent of its funds outside China.

§The China-Africa Development Fund is a small fund set up to foster economic ties between China and Africa. It functions as a branch of China Development Bank, China's largest policy bank, though various government ministries are represented on its board. It is worth noting that the China Development Bank is majority owned by Central Huijin, the domestic subsidiary of CIC.

¶CIC is a participant in the International Forum of Sovereign Wealth Funds (IFSWF) and has endorsed the Generally Accepted Principles and Practices, or "Santiago Principles," a set of recommended practices for sovereign wealth funds that calls for increased transparency. SAFE, however, does not participate in the IFSWF.

Rising Competition among China's Sovereign Wealth Funds—Continued

China's sovereign wealth funds rank among the world's largest in terms of assets and have developed substantial portfolios in the United States. CIC has acquired stakes in and loaned capital to major U.S. companies in energy and financial services.⁹⁴ CIC's subsidiary, the bank holding company Central Huijin, also owns shares in China's largest commercial banks, which have opened branches in the United States.⁹⁵ SAFE has become a more aggressive investor and has moved beyond U.S. Treasuries to riskier asset classes.⁹⁶ In 2013, SAFE opened a new branch in New York that will invest in U.S. private equity and real estate.⁹⁷ In addition, China's sovereign wealth funds are contracting U.S. fund managers, such as Blackrock and TPG, to manage large portions of their portfolios.⁹⁸

Foreign exchange is being channeled into overseas lending as well. Among the top lenders is China Development Bank, China's largest policy bank. The bank was established in 1994 to subsidize development projects in China's most backward regions but has vastly expanded its dollar-denominated loan portfolio in recent years. In May, it signed a \$1 billion oil-for-loan deal with India's largest oil company, Essar Oil Ltd. China Development Bank has issued several such loans to energy-rich countries since 2007, notably Venezuela, Russia, and Brazil.⁹⁹

Currency Inflows and the Cash Crunch

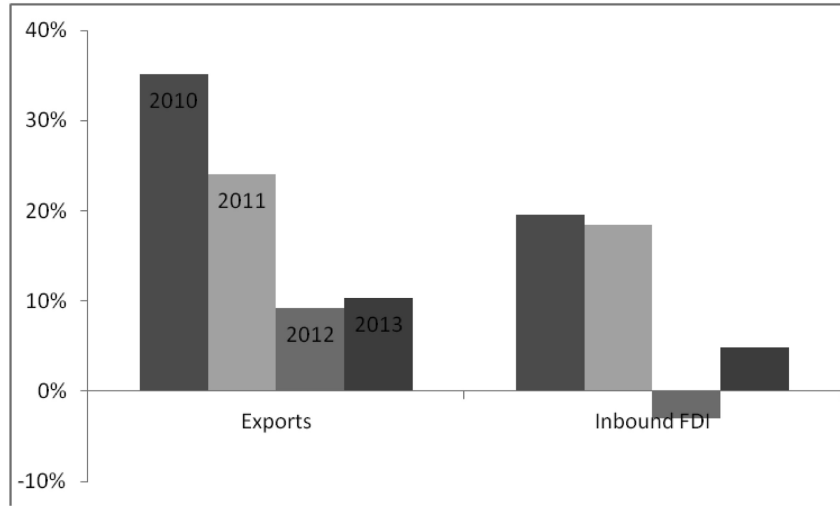
China's foreign currency inflows in the first half of 2013 were large but volatile: reserve accumulation surged in the first quarter, followed by outflows in the second quarter.¹⁰⁰ Volatility in China's external accounts carried over into the domestic financial sector, which encountered a temporary liquidity crisis. The central bank intervened to maintain stability in a slowing economy exposed to high levels of debt.

Export earnings and inbound FDI grew at a slow pace in the first half of 2013, making only a moderate contribution to China's dollar inflows (see figure 8). China's foreign exchange reserves increased by \$128 billion in the first quarter, well above the \$43 billion trade surplus and \$30 billion in foreign investments.¹⁰¹ Other factors, less tied to the health of the economy, played a significant role in attracting capital to the Mainland. One was the reversal of capital flight. According to a February 2013 briefing to the Commission by the U.S. Treasury, many wealthy individuals took money out of the country during China's once-in-a-decade leadership transition in 2012, due in part to concerns about political and economic instability.¹⁰² China's central bank records indicate that some \$79 billion of foreign exchange outflows went unaccounted for. The outflows of capital were so large that China's foreign exchange reserves in 2012 grew by less than the trade surplus—a pattern not seen since China joined the World Trade Organization (WTO). The resumption of currency inflows in early 2013 suggested that some of the flight capital reentered the country.¹⁰³ Due to China's tight

capital controls, a considerable portion of the inflows entered illicitly through over-invoicing of export revenues and other means.¹⁰⁴

Figure 8: Growth of China's Exports and Inbound FDI
(January—June, 2010–2013)

YTD (year-on-year, %)



Source: China General Administration of Customs, China Ministry of Commerce, via CEIC database.

Another factor behind China's surging capital inflows was financial speculation. International investors borrowed U.S. dollars at low rates of interest to purchase assets denominated in RMB, which offered a higher yield and the potential to profit from currency appreciation. Although the RMB did not appreciate much in 2012, the upward pressure on the currency resumed in 2013. This investment pattern was reinforced by the U.S. Federal Reserve's purchases of longer-maturity assets, such as commercial bank bonds, under the stimulus program known as "quantitative easing." First implemented in November 2008, quantitative easing substantially lowers the longer-term cost of borrowing in dollars.¹⁰⁵

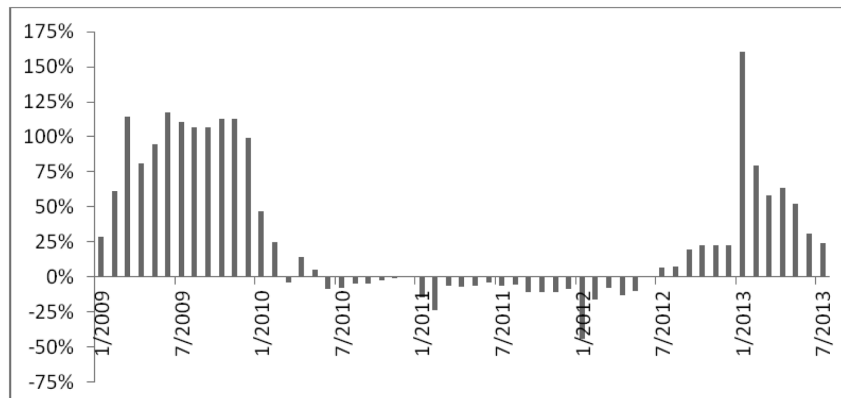
As it has done persistently since 2005, the PBOC counteracted rapid capital inflows by heavy market intervention. The PBOC purchased dollars with RMB in order to support the targeted RMB-dollar exchange rate. That not only added to the PBOC's bulging foreign exchange reserves but also increased China's money supply, raising the risk of inflation. To reduce those risks, the PBOC took additional "sterilization" measures to absorb liquidity out of the economy—essentially issuing RMB-denominated bonds in an effort to remove the money from circulation.¹⁰⁶

Nonetheless, the liquidity buildup contributed to an expansion of lending and debt in China. The broad money supply (M2)* grew by

* Broad money (M2) is a measure of liquid money supply beyond physical currency and demand deposits (also termed narrow money, or M1). M2 includes time-related deposits, savings deposits, and noninstitutional money market funds.

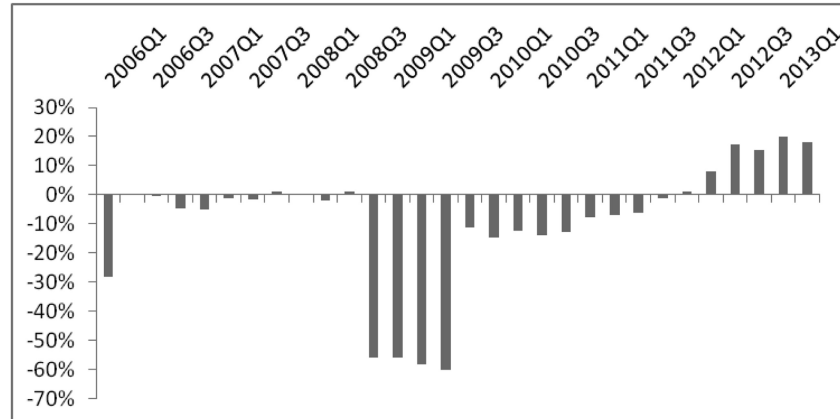
16.1 percent through April, above market forecasts of 15.5 percent.¹⁰⁷ The Chinese government’s measurement of debt, or “total social financing,” rose at its fastest pace since the stimulus in 2009 (see figure 9). Much of this credit expansion was in the “shadow banking” sector, in products such as trust company loans.¹⁰⁸ At the same time, worrying trends appeared in the traditional banking sector. Foreign currency lending increased by 37 percent year-on-year through May—versus 16 percent for RMB-denominated loans—as banks recycled the excess dollars coming into their accounts.¹⁰⁹ Chinese banks are less restricted in terms of the amount of deposits they need to have available when lending in foreign currency, a loose regulation that prompts riskier lending. Nonperforming loans at Chinese banks also grew at their fastest quarterly rate in a decade; an indication that credit was not well allocated (see figure 10).

Figure 9: Aggregate Credit Growth in China, January 2009–July 2013
Monthly (year-on-year, %)



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

Figure 10: Growth of China's Nonperforming Loans, 2006–2013Q1
Quarterly (year-on-year, %)



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

Faced with a sudden rise in liquidity, the PBOC in June began to take more drastic measures, such as imposing tougher lending conditions on banks. These policies, which came to be known as the “credit crunch,” were effective in reducing dollar inflows. A concurrent development was the U.S. Federal Reserve’s announcement in May that it might taper quantitative easing, a major policy shift that would raise the cost of borrowing in dollars and reduce the relative yield on RMB-denominated assets. In response to the Federal Reserve’s announcement, international investors rushed to transfer funds out of China and other emerging markets.

However, the credit crunch also destabilized China’s financial sector. The primary effect was to raise interest rates in the inter-bank lending market to record highs—lending among Chinese banks froze temporarily in late June. Many indebted borrowers worried that they would be unable to refinance their debt.¹¹⁰ The average price-to-earnings ratio for China’s major commercial banks fell sharply on the country’s major stock exchanges, part of a broader decline in China’s capital markets.¹¹¹

Ultimately, the cash crunch did not do much to rein in China’s debt. Once the initial scare of tight liquidity passed, aggregate credit growth continued to rise in June and July. Even as banks have found themselves increasingly strapped for cash, other signs indicate that they may actually be expanding their issuance of risky loans. Shortly after the engineered rate spike that froze inter-bank lending, nearly every major Chinese bank was selling a short-term wealth management product (a particularly popular vehicle for financing high interest rate, off-balance-sheet loans) that had to be completed by the end of June.¹¹² (For more on shadow banking, see chap. 1, sec. 3, of this Report.)

Capital Account Liberalization

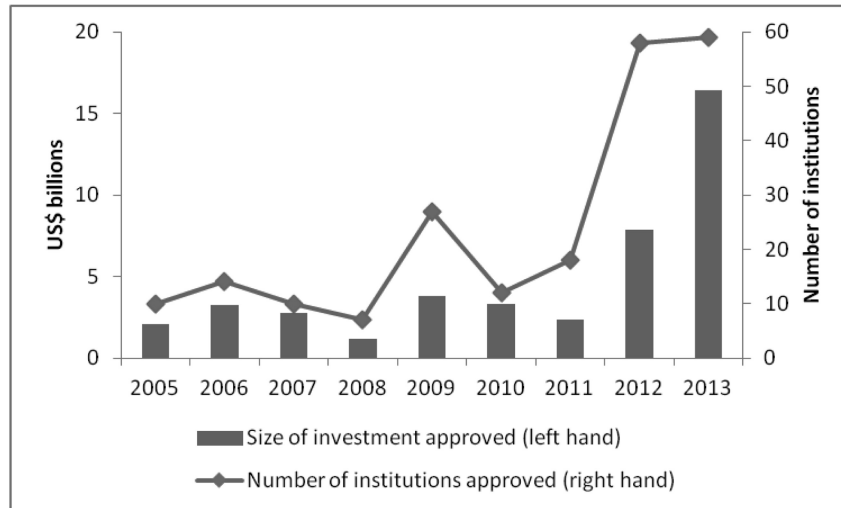
Beijing took moderate steps in 2013 to further open its capital account. The primary motive was to attract foreign investors, an

indirect way to stimulate a sluggish economy. Financial regulators launched the Qualified Foreign Institutional Investor program in 2002 to allow licensed foreign investors to buy and sell shares on China's stock exchanges. China's central bank and securities regulators approve any increase in the number of institutions and the amount of funds that these institutions can invest in China under the scheme. In 2013, the Qualified Foreign Institutional Investor program saw its largest-ever increases in investment approvals (see figure 11). Most of the approvals were given to investors who already held Qualified Foreign Institutional Investor licenses.

In addition to individual approvals, the quota for total investment under the Qualified Foreign Institutional Investor program was increased from \$80 billion to \$150 billion. Raising the quota seemed relatively pointless; with total cumulative funding approvals of \$43 billion over 11 years, even the original \$80 billion quota has yet to be filled. Nonetheless, the policy had its intended effect of generating interest among foreign investors, as several financial services companies quickly applied for a larger quota.*

Figure 11: Increase in Investment Quota under the Qualified Foreign Institutional Investor Program, January-July, 2005-2013

(US\$ billions)



Source: China State Administration of Foreign Exchange, via CEIC database.

The RMB Qualified Foreign Institutional Investor program, first established in December 2011 to complement the Qualified Foreign Institutional Investor program, was also expanded. Whereas the Qualified Foreign Institutional Investor program allows investors to bring U.S. dollars onshore and exchange them into RMB, the

* According to the Qualified Foreign Institutional Investor program, the China Securities Regulatory Commission grants Qualified Foreign Institutional Investor licenses and market access to foreign investors, while the State Administration of Foreign Exchange approves quotas for individual Qualified Foreign Institutional Investor funds. Josh Noble, "China Approves HSBC for Onshore Currency Investing," *Financial Times*, July 26, 2013, via Factiva database.

RMB Qualified Foreign Institutional Investor program allows select institutions to raise RMB offshore as well.¹¹³ RMB Qualified Foreign Institutional Investor funding approvals reached \$20 billion by July 2013, four times higher than the year before, with 34 institutions approved for investment.¹¹⁴ The China Securities Regulatory Commission removed rules on how quotas could be used, so that fund managers could invest in either China's equity or domestic bond markets without requiring separate licenses.¹¹⁵ The China Securities Regulatory Commission also allowed units of Chinese banks and insurers in Hong Kong—as well as other financial institutions based in the city—to apply for RMB Qualified Foreign Institutional Investor quotas. Previously, only the Hong Kong units of Chinese fund management and securities companies were allowed to invest in mainland China via the program.¹¹⁶ In June, the RMB Qualified Foreign Institutional Investor program was then extended beyond Hong Kong to other offshore RMB trading centers, such as London, Singapore, and Taiwan, to the dislike of mainland Chinese fund managers who hoped to monopolize this new market.¹¹⁷

It is questionable, however, whether the Chinese government is making a genuine effort to open the capital account or is merely luring foreign investors into China to stimulate the economy. It has done much less to open up the capital account for Mainland investors looking to send money overseas. Chinese domestic investors are allowed to access foreign equity markets via pilot trustees called Qualified Domestic Institutional Investors, which comprise banks, fund management firms, insurance companies, dealers, and brokers approved by the China Securities Regulatory Commission.¹¹⁸ The amount of investment permitted for Qualified Foreign Institutional Investors barely increased in the first half of 2013.¹¹⁹ The government announced plans in 2012 to introduce a Qualified Domestic Individual Investor program that would permit individuals from the Mainland to trade Hong Kong securities directly. By October 2013, the plan had yet to proceed.¹²⁰ The government in 2013 introduced a less ambitious Qualified Domestic Institutional Investors scheme that would allow firms set up in the new Qianhai special economic zone to invest a certain amount of money in Hong Kong securities or bond markets.¹²¹

Excess Industrial Capacity

The Excess Capacity Crisis

In 2012–2013, China's manufacturers recorded their worst performance since the height of the financial crisis four years ago. Monthly growth in China's industrial production, averaging 13.3 percent in 2010, slowed to 6.1 percent in the first half of 2013. The purchasing managers' index, a monthly survey of manufacturers in China, consistently showed stagnation or decline in production and orders. China's exports were also sluggish, due to weak external demand.¹²² The construction sector, a key source of demand for many industrial materials, recovered slightly in the first half of 2013 from 2012 levels but was still growing at 7 percentage points less than in 2010–2011.¹²³

The economic slump exacerbated the problem of excess capacity in China's heavy industry. The sectors affected extended along the value chain, from suppliers of basic materials, such as metals and cement, to manufacturers of ships, solar panels, and chemical additives. China today is the world's leading producer of most of these goods. According to official estimates, industrial enterprises in many of these sectors were operating at only three-fifths to three-quarters of capacity in 2012, below the Chinese government's target minimum of 80 percent capacity (see table 2).

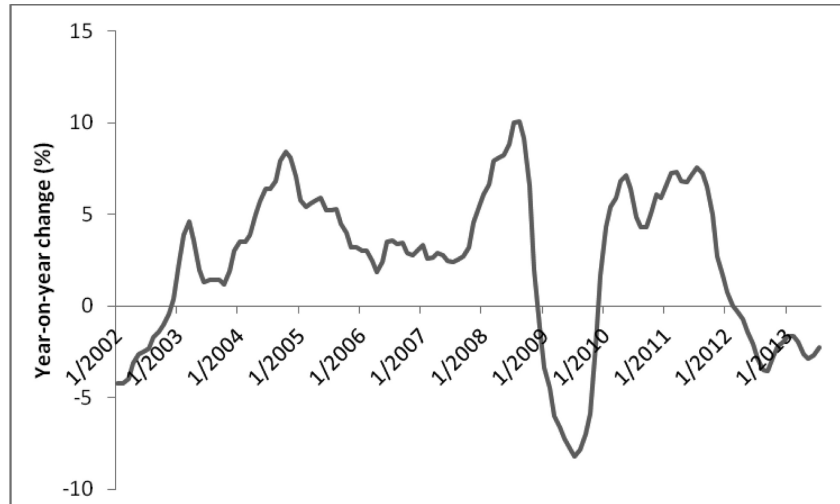
Table 2: Capacity Utilization in Select Chinese Industries, 2012
Capacity utilization (%)

Sector	Capacity utilization (%)
<i>Chinese government target</i>	>80%
Glass	75%
Cement	75%
Aluminum	73%
Wind turbine	70%
Steel	75%
Solar panels	60%

Source: Xinhua News Agency, based on official Chinese government estimates.

Due to excess capacity, business conditions in many industries deteriorated. In order to sell off their inventory and attract new orders, producers slashed prices, leading China's producer price index to contract throughout 2012–2013 (see figure 12). Some enterprises took on more debt in order to offer generous financing terms to their customers. Shipyards, for instance, accepted down payments of just 5 to 10 percent for new orders, versus up to 60 percent at the high mark in 2007.¹²⁴ To some extent, these measures proved effective—the total losses of the industrial sector, and the total number of loss-making industrial enterprises, declined in the first half of 2013, after steep increases in 2012.¹²⁵

Figure 12: Producer Price Index in China, January 2002–July 2013
Monthly (year-on-year change, %)



Source: China National Bureau of Statistics, via CEIC database.

Still, many firms incurred debts that brought them to the brink of insolvency. Among 88 private steel enterprises, the number of companies suffering losses grew from a third to half in 2012–2013.¹²⁶ In the solar sector, China's state-owned banks grew wary of lending to panel makers after product prices fell 66 percent in two years.¹²⁷ Suntech Power, the world's largest solar panel manufacturer, declared bankruptcy in March 2013 after running out of cash and defaulting on a bond payment of more than \$541 million.¹²⁸ In the shipbuilding sector, China Rongsheng Heavy Industries Group Holdings Ltd., a publicly listed company and China's largest private shipyard, sought a bailout in July from the local government in Jiangsu Province.¹²⁹ In its 2012 annual report, Rongsheng acknowledged that it had only \$343 million of cash and cash equivalents to service debts of \$2.7 billion.¹³⁰

Although producers were affected by a slowing economy, structural imbalances and ineffective government policies created the underlying problem. China's industrial sector remains very fragmented. For example, while Japan and South Korea have only a few dozen large-scale shipyards, China has some 1,650 yards of various sizes. Such industrial enterprises have failed to coordinate production or pool resources on a national level, creating cut-throat competition in undifferentiated product lines. They have done so with subsidies from local governments keen on attracting business to grow the economy and raise government revenue. Low-interest-rate loans from state-owned banks, with a bias toward industrial enterprises, created additional capacity without regard for insufficient demand. The 2009 economic stimulus accelerated this pattern. Fixed asset investment in manufacturing grew by an average of 35 percent in 2010–2011.¹³¹ For 35 steel companies listed on the Shanghai and Shenzhen stock exchanges, local government sub-

sidies increased by 128 percent year-on-year in 2010–2011.¹³² One shipbuilder, Rongsheng, received some \$550 million in local government subsidies in 2010–2013, along with two five-year financing deals with Export-Import Bank of China, a Chinese policy bank, and a ten-year agreement with Bank of China, one of China’s “Big Four” commercial banks.¹³³

Reinforcing these patterns was the deliberate expansion of productive capacity in China’s poorer inland regions. In the case of aluminum, more than 90 percent of new capacity has emerged in western areas since 2010. Excess capacity in the cement industry was as high as 30 percent in the Northeast and West of the country, versus 10 to 15 percent in the more developed eastern regions.¹³⁴ Industrial enterprises have relocated to where land and labor are cheaper, urban density is lower, and local governments are less likely to enforce environmental regulations decreed by the central government.¹³⁵

Some of China’s industries have also fallen behind their international competitors, who have performed better in a difficult economic climate. In the aluminum sector, the U.S. firm Alcoa registered profits of \$191 million in 2012, while China’s aluminum giant Chinalco had a loss of \$780 million, its worst since going public in 2007.¹³⁶ In shipbuilding, China in 2012 received orders of \$14.3 billion, its lowest order value since 2004, while its South Korean rivals received \$29.6 billion worth of new orders.¹³⁷

Market forces are unlikely to correct the structural problems of China’s heavy industry. Heavily indebted firms often have an incentive to maintain current output levels, because their loans are contingent upon future output. Due to fierce competition, there is also a concern that distributors will turn to other producers if deliveries are cut. Because many local communities depend on industry for employment, it is difficult to reduce pay or shed jobs. For example, Wuhan Iron and Steel, one of China’s top-five steelmakers, supports a workers’ town of 300,000 people in Hubei Province.¹³⁸

While such overcapacity is harmful to the affected Chinese industries and individual businesses, as well as any shareholders involved, it also spreads damage beyond China’s borders. Industries within the United States, such as steel and glass, are sometimes forced to match the “China price” even if it is below the cost of production, leading to business losses and unemployment.

Tougher Policy Responses by the New Leadership

Excess capacity in China’s industry is not a new problem. The central government’s restructuring of the country’s state-owned enterprises in the 1990s was partly aimed at reducing overcapacity, particularly in the industrial northeast. The 11th Five-Year Plan (2006–2010) focused on the consolidation of capacity, and in the 12th Five-Year Plan (2011–2015), issued in 2010, the State Council introduced a specific five-year Plan for Industrial Transformation and Upgrading.¹³⁹ An important proponent of consolidation has been the NDRC, the coordinating ministry in charge of China’s industrial policy. In September 2009, it issued Document 35, “On Restraining Excess Capacity and Industrial Redundancy in Certain Industries.” The document identified industries such as steel, ce-

ment, aluminum, and shipbuilding. It placed much of the blame on the lavish subsidies and lax regulation of local governments and warned that unchecked capacity expansion would eventually lead to fierce competition and cost-cutting at the national level, threatening the financial health of enterprises and their creditors; depleting China's resource base; increasing reliance on raw material imports; and worsening industrial pollution near urban centers.¹⁴⁰

However, these efforts by the government did not suffice to check industrial expansion. Instead, industrial capacity continued to increase under the \$586 billion economic stimulus program introduced during the global financial crisis. The EU's Chamber of Commerce in China warned in a 60-page report in 2009 that industries such as steel, cement, and plastics were "still blindly expanding" despite a slump in export demand. Referring to the steel industry, the report noted that China, with annual production capacity of 660 million tons of steel, and with an additional 58 million tons coming online, had sold less than 500 million tons the previous year.¹⁴¹ With 20 million tons of primary aluminum capacity in 2008, China could sell only 13.5 million tons, or just 68 percent of its capacity.¹⁴²

By the spring of 2013, during the National People's Congress's annual meetings, top officials openly acknowledged that excess capacity was untenable, particularly in the steel sector. NDRC head Zhang Ping urged "mergers and acquisitions, eliminating backward production, and encouraging more companies to tap into the overseas market."¹⁴³ In April, the new leadership took its first tentative steps to address the issue. Based on a comprehensive set of criteria, including product quality, environmental sustainability, and resource efficiency, the Ministry of Industry and Information Technology (MIIT) chose 45 out of a pool of 104 enterprises for consolidation of the steel industry under the 12th Five-Year Plan. MIIT announced that those companies that could not meet the criteria would eventually be forced to exit the market, either by legislative fiat or reduced access to capital.¹⁴⁴

From June to August, the government's efforts to reduce capacity intensified. The "credit crunch" in June, widely attributed to China's central bank, helped to clamp down on short-term borrowing, forcing dozens of companies to cancel or delay bond sales, including China Development Bank, a key backer of the shipping industry.¹⁴⁵ Weeks after the credit crunch, the central bank lifted the floor on bank lending rates. According to economist Nicholas Lardy, at the Peterson Institute for International Economics, the leadership used the credit crunch and rate reform to signal that the corporate sector would need to cut costs and improve productivity in order to remain profitable.¹⁴⁶

Beijing followed with more targeted measures aimed directly at heavy industry. The most far-reaching measure came on July 25, when MIIT ordered more than 1,400 companies in 19 industries to permanently retire entire production lines within factories by the end of 2013. In a break from past policy, the government published detailed lists of exactly which plants should reduce capacity and by how much.¹⁴⁷ The lists were downloadable from the MIIT website and included publicly listed companies, some of which saw their share price drop as a result.¹⁴⁸ Although the industries were wide-

ranging, the companies targeted were primarily in metals, cement, and other basic materials.¹⁴⁹ MIIT reinforced these policies with specific documents targeting the aluminum and rare earths sectors.*

On September 17, MIIT released another list for industrial capacity retirement—the third of the year—involving a total of 58 companies operating in 14 sectors. The affected industries were largely the same as before, comprising steel, coking, battery, copper smelting, zinc smelting, cement, and plate glass, among others. Black-listed capacities were to be demolished before the end of the year. MIIT expressly forbid the relocation of production to the hinterland.¹⁵⁰

A Lenient Approach to the Shipbuilding and Solar Photovoltaic Industries

Although the central government took concrete steps to rationalize production, vested interests appeared to impede similar efforts in the shipbuilding and solar photovoltaic sectors. A three-year plan to upgrade the country's shipbuilding industry, released by the State Council on July 31, encouraged local governments to provide subsidies to shipbuilders. It also offered ship-holders incentives to scrap their ships in advance, until the end of 2015, in order to raise demand for new ships. Banks were ordered to extend favorable loans to overseas ship-buyers and provide credit support to domestic ship-builders. Although the plan also called for industry consolidation, the measures were less targeted at individual plants.¹⁵¹

Similarly, in the “Guidance on Promoting the Healthy Development of the Solar Industry,” issued on July 15, the State Council announced new measures to spur solar panel installations. The policy called for raising the capacity target for solar power generation in China to 35 gigawatts (GW) by 2015, a large step up from the 21 gigawatt target set in the 2011–2015 Solar Development Plan issued by the National Energy Administration in 2012.¹⁵²

The Chinese government also supported the solar industry through an aggressive trade policy. China followed through on a probe it launched in 2012 into alleged subsidies for U.S. and South Korean polysilicon producers, applying antidumping duties on these imports in July 2013. Many critics interpreted the move as retaliation for U.S. antidumping duties leveled against Chinese solar panel makers in September 2012. The duties also protect China's domestic polysilicon industry, which is suffering from over-capacity.¹⁵³

*MIIT in July convened several agencies, including the Environment Ministry, Customs, the Ministry of Land and Resources, and the Ministry of Commerce, to deliberate a new wave of crackdowns in the rare earths industry, with a focus on rooting out illegal production through higher fines and the closure of mines and smelting facilities. On July 24, MIIT released new aluminum industry standards: only large alumina projects would be authorized to use imported bauxite; alumina projects using high-aluminum fly ash for production were to locate in a place close to fly ash production, to reduce pollution; and the minimum capital ratio of electrolytic aluminum projects was raised to 40 percent from the previous 35 percent, to ensure less leveraged investments in new capacity. Shanghai Securities News, “Zhengzhi fang'an' lidu kongqian: Xitu jiage fantan huo zhicheng” (‘Unprecedented Crackdown’ to Support Price Rebound for Rare Earths) July 23, 2013, p. 5; Xinhua's China Economic Information Service, “MIIT Rolls Out Policies to Resolve Excess Aluminum Capacity,” July 24, 2013, via Factiva database.

In parallel to its rift with the United States, China engaged in a protracted trade dispute with the European Union, which in May 2013 threatened to apply antidumping duties on Chinese solar panels, similar to those being enforced by the United States.¹⁵⁴ The proposed duties, averaging 47.6 percent, would have been the largest duties that the European Union has applied to China and involved some \$27 billion worth of imports.¹⁵⁵ The Chinese government made extensive efforts to block the duties. In mid-May, the Ministry of Commerce (MOFCOM) warned that imposing duties would “seriously harm” bilateral trade ties between the European Union and China.¹⁵⁶ A statement posted on the Chinese government’s main website on May 30 asserted that EU member states did not all agree on the need for the tariff duties.¹⁵⁷ Premier Li Keqiang used his first trip to Europe to encourage Germany and other major countries to oppose the measures.¹⁵⁸

China’s diplomatic offensive proved effective. On June 4, the European Commission agreed to temporarily lower the new tariffs from the proposed level of 47.6 percent to a mere 11.8 percent, while the two sides attempted to negotiate a solution.¹⁵⁹ In late July, China scored a major victory in the negotiations, as the European Union agreed to scrap its proposed duties in favor of a “price undertaking.” The settlement allows Chinese exporters to sell into the European Union only enough solar panels to generate up to seven GW of capacity each year, at a minimum price of 0.56 euros per watt. Only Chinese firms that do not comply are subject to duties. The outcome effectively permitted China’s subsidized solar panel exports to the European Union to continue unabated, only at a higher sales price. As *The Wall Street Journal* noted, the deal was much like the voluntary export restraints negotiated between the Japanese and U.S. governments in the 1980s.¹⁶⁰

U.S.-China Strategic and Economic Dialogue

The fifth round of the U.S.-China Strategic and Economic Dialogue (S&ED) was held on July 10–11, 2013, in Washington, DC. Prior to the S&ED, the United States and China held the first meeting of the civilian-military Cyber Working Group, where the two sides committed to work together on cooperative activities and hold further discussions on international norms of state behavior in cyberspace, but there were no tangible results.¹⁶¹ Both sides agreed to hold the next meeting before the end of 2013. (For discussion of U.S.-China tensions over cybersecurity, see chap. 2, sec. 2, of this Report.)

On the economic front, the most relevant announcements were (1) resumption of Bilateral Investment Treaty (BIT) talks; (2) the launch of the Shanghai Free Trade Zone; and (3) new measures to liberalize China’s financial sector.

Announcement 1: BIT Talks Resumed

Of the economic outcomes, the most significant development was an agreement to restart the 2008 talks to reach a BIT. Six months before leaving office, the Bush Administration had launched talks for a U.S.-China BIT. In November 2009, President Obama then issued a joint statement with President Hu Jintao, announcing

plans to expedite these negotiations. Until now, little progress has been made.¹⁶²

At the S&ED talks, China agreed to negotiate market access using a “negative list” approach (which means that all sectors are negotiable, except for those specifically exempted). China also agreed to grant U.S. investors national treatment in the “pre-establishment” phase of investment, or before U.S. firms are actually invested in China. This means, for example, that China will not discriminate against U.S. firms while they are trying to obtain a license or treat them differently than a domestic firm.¹⁶³

Treasury Secretary Jacob Lew described this as a “significant breakthrough” that “would work to level the playing field for American workers and businesses by opening markets for fair competition.”¹⁶⁴ U.S. business groups welcomed the development as a possible solution to Chinese opposition to foreign investment in large sectors of the Chinese economy, most notably financial services.

Others have urged caution, however. Dr. Lardy called the BIT “a noble goal but one which will be very difficult to conclude in any reasonable time period and it might well fail.”¹⁶⁵ Derek Scissors, then at the Heritage Foundation, was similarly skeptical, noting, “BITs are primarily about protecting investors from discriminatory government policies. They are not transformative instruments that change the nature of economies, especially not large economies.”¹⁶⁶

A comprehensive BIT with China would be highly controversial and involve protracted Senate debate over details. BITs are treaties rather than executive agreements,* such as the North American Free Trade Agreement, and require a two-thirds vote of the Senate to ratify. A BIT would also potentially curtail the powers of state and local governments to regulate health and safety issues and even zoning, raising sovereignty concerns. Moreover, with the exception of a few failed deals, Chinese firms have had success investing in the United States even without an investment treaty. Similarly, U.S. companies have been investing in China for years, fully cognizant of various restrictions on investment, policies that discriminate against foreign investors in favor of Chinese firms, and rampant intellectual property rights theft. China may not be willing to make major concessions for a deal.

Announcement 2: Shanghai Free Trade Zone

At the S&ED talks, China also agreed to expand access to its financial services sector for foreign investors. The most relevant outcome involves the establishment of a pilot free trade zone in Shanghai, which will guarantee equal access to domestic and foreign enterprises. Led by Premier Li, the State Council approved the plans on July 3, a week prior to the S&ED talks. Unlike China’s existing special economic zones, which were established in the early 1980s to attract foreign investment in manufacturing to boost exports, the Shanghai free trade zone will not simply provide fiscal and other incentives; it will also serve as a platform to test an assortment of controversial market reforms.¹⁶⁷

*Free trade agreements are generally passed under an expedited “fast track” rule that does not allow amendments on the floor and calls for expedited procedures.

China's Ministry of Commerce approved the establishment of the free trade zone in August 2013, touting it as a "new path and a new mode of opening to the outside world."¹⁶⁸ After months of media speculation, on September 27, 2013, the State Council released rules to govern the new free trade zone. Beijing has agreed to allow RMB convertibility and market-based setting of exchange rates and interest rates, the first such steps toward full currency convertibility.¹⁶⁹ Financial institutions in the zone would be allowed more freedom to experiment with new products and services, which may allow foreign firms to increase the quantity and sophistication of financial products. The government also pledged to open up shipping, commerce, specialized services (including legal), and travel. Further details remain vague. No specific timeline was given for implementing any of the reforms, though the State Council announcement said that financial liberalization will proceed "as conditions allowed" and "risks would be controlled," forestalling any suggestion of rapid change.¹⁷⁰

The government announced that unlike other Chinese free trade zones the investment at the Shanghai free trade zone will be governed by a "negative list" approach. The use of the negative list suggested that the ability of Chinese regulators to arbitrarily constrain foreign investors might be curtailed. However, expectations for broad reform were dampened following the publication of this list by Shanghai government officials.¹⁷¹ The list includes restrictions covering 18 sectors, including finance, media, utilities, property, and manufacturing.¹⁷² Analysts and banking officials noted that the wide range of restrictions reflects continued jockeying among Chinese government officials over the speed of liberalization.¹⁷³ The list applies to the remainder of 2013 and will be updated as the government continues testing liberalization policies in the free trade zone.

The *South China Morning Post*, a Hong Kong publication, reported that the government would suspend some Internet controls, granting people inside the Shanghai free trade zone access to websites blocked elsewhere in the country, such as Facebook and Twitter.¹⁷⁴ However, the statement by the State Council did not mention any such change. It did say foreign companies might be allowed to offer "specialized telecommunications services" in the zone, and permission to offer services that break existing Chinese laws might be granted on a case-by-case basis by the State Council.¹⁷⁵

The new pilot zone will take up to ten years to construct and will cover 28 square kilometers within Shanghai's existing Waigaoqiao bonded trade zone and three other special customs supervision zones. If successful, the model may be replicated nationwide. In response to the Shanghai free trade zone, other port cities, including Xiamen and Tianjin, have expressed interest in establishing similar pilot zones.¹⁷⁶

Announcement 3: Financial Sector Liberalization

As in past S&ED talks, China once again promised to move toward a market-determined exchange rate and to submit another proposal to join the WTO's Government Procurement Agreement. After China was admitted to the WTO in 2001, it agreed to sign

the procurement agreement “as soon as possible.” However, its first bid was only submitted in February 2008. Because the terms of accession that China offered did not satisfy other WTO members, China subsequently submitted two more bids, the latest in November 2012. Three bids are generally the maximum required for Government Procurement Agreement applicants; yet several obstacles make China’s imminent accession unlikely, not least its huge public sector and narrow definition of procurement in domestic law. China has resisted U.S. demands to include SOEs as government entities that would be bound by the agreement.

China also hinted at greater market access for U.S. financial firms, particularly in trading government bond futures and underwriting corporate bonds. This form of foreign participation would be conducive to China’s financial sector reform, as the government seeks novel ways to raise funds for companies while reining in credit issued by trust companies, local government financing vehicles, and other nontraditional lenders. China also welcomed participation by foreign banks in RMB settlement of cross-border trade and investment.¹⁷⁷ A day after the adjournment of the S&ED talks, China announced that the Qualified Foreign Institutional Investor program will expand to \$150 billion (the current quota stands at \$80 billion, but only \$43 billion of that has been allocated for use in investment).¹⁷⁸ A similar plan for Hong Kong-based RMB investors will grow to encompass Singapore, London, and other cities.¹⁷⁹

China’s securities regulator also announced at the S&ED talks that it will begin providing certain audit work papers to the U.S. Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board, a first step toward resolving a longstanding impasse on enforcement cooperation related to companies that are listed in the United States. U.S. and Chinese audit regulators also committed to accelerating cooperation for cross-border audit oversight.¹⁸⁰ However, the S&ED joint factsheet makes no mention of a formal mechanism for sharing audit papers, so much work remains to be done on this issue. (For further discussion of the U.S.-China friction over the audit issue, see chap. 1, sec. 3, of this Report.)

The U.S.-China Relationship at the WTO

On August 2, 2013, a WTO panel found that China had violated WTO rules in applying antidumping (AD) and countervailing duties (CVD) on U.S. exports of chicken broiler products.* China’s MOFCOM imposed AD and CVD on these products in August and September 2010, respectively. The AD duties ranged from 50.3 percent to 53.4 percent for the U.S. producers who responded to MOFCOM’s investigation notice, while MOFCOM set an “all others” rate of 105.4 percent. In the CVD investigation, MOFCOM imposed CVDs between 4 percent and 12.5 percent for the participating U.S. producers and an “all others” rate of 30.3 percent. According to the Office of the U.S. Trade Representative, U.S. exports to China of broiler products fell by 80 percent following the applica-

*Broiler products include most chicken products, with the exception of live chickens and a few other products such as cooked and canned chicken.

tion of the duties.¹⁸¹ The United States brought the case in September 2011.

In its report, the WTO dispute settlement panel found in favor of the United States on nearly all U.S. claims, including substantive errors in MOFCOM's calculations and procedural errors.¹⁸² The United States scored a major victory against China's use of the average cost of production methodology in calculating dumping margins (i.e., the difference between the price of poultry products in the U.S. market and the price of the same product in China). In order to estimate the cost of production for a given chicken part, China would estimate the average cost of producing a whole chicken and assign the cost of producing that part depending on its weight. The United States argued that this methodology dramatically overestimated the cost of production for cheap parts of a chicken, such as paws.¹⁸³ Both sides agreed not to appeal the ruling, and it was adopted by the WTO on September 25, 2013.

In addition to the broiler case, there are pending WTO cases between the United States and China, whose status is summarized in tables 3 and 4 below.

Table 3: Active WTO Cases Brought by the United States against China

No.	Title	Request for Consultations	Panel Report	Appellate Body Report	Compliance Status
DS419	Measures concerning wind power equipment	December 22, 2010	In consultations; panel not yet formed		
DS427	Antidumping and Countervailing Duty Measures on Broiler Products from the United States	September 20, 2011	August 2, 2013	N/A	The panel upheld most U.S. claims. The two sides agreed not to appeal the ruling
DS431	Measures Related to the Exportation of Rare Earths, Tungsten, and Molybdenum	March 13, 2012	Panel composed September 24, 2012; report pending		
DS440	Antidumping and Countervailing Duties on Certain Automobiles from the United States	July 5, 2012	Panel composed February 11, 2013; report pending		
DS450	Certain Measures Affecting the Automobile and Automobile-Parts Industries	September 17, 2012	In consultations; panel not yet formed		

Source: WTO Dispute Settlement Gateway. www.wto.org.

Table 4: Active WTO Cases Brought by China against the United States

No.	Title	Request for Consultations	Panel Report	Appellate Body Report	Compliance Status
DS437	Countervailing Duty Measures on Certain Products from China ¹⁸⁴	May 25, 2012	Panel composed November 26, 2012; report pending		
DS449	Countervailing and Antidumping Measures on Certain Products from China ¹⁸⁵	September 17, 2012	Panel composed March 4, 2013; report expected by December 2013		

Source: WTO Dispute Settlement Gateway. www.wto.org.

China's Preferential Trade Agreements

Following its accession to the WTO, China has actively worked to negotiate and implement bilateral and multilateral trade agreements across the globe. As China transforms from a regional player to a global power, it has not only created a growing web of international legal obligations but has also gradually advanced its economic and political influence. As of August 2013, China has signed thirteen preferential trade agreements (PTA),* including two with Iceland and Switzerland this year. The Iceland and Switzerland PTAs were the first signed between China and European countries—both representing a significant milestone in strengthening China's trade relationship with Europe.¹⁸⁶ China is currently in the process of negotiating additional bilateral and multilateral PTAs with neighboring and distant countries, each encompassing particular economic and political motives (see table 5).

Table 5: Preferential Trade Agreements with the PRC

Signed Trade Agreements	Asia-Pacific Trade Agreement (2000) Hong Kong (2003) Macau (2003) ASEAN (2004) Chile (2005) Pakistan (2006) New Zealand (2008) Singapore (2008) Peru (2009) Taiwan (2010) Costa Rica (2010) Switzerland (2013) Iceland (2013)
Under Negotiations	Norway China–Japan–Korea Australia Gulf Cooperation Council (GCC) Regional Comprehensive Economic Partnership (RCEP)
Under Consideration	India Korea Colombia

Notes: Number in parentheses indicates the year initial agreement of PTA was signed. ASEAN=Association of Southeast Asian Nations

Source: Liu Debiao, "Zhongguo Ziyou Maoyi Xieding Gailun" (Introduction to China's Free Trade Agreements) (Beijing, China: China Commerce and Trade Press, June 2012), p. 10; Ministry of Commerce, *China FTA Network* (Beijing, China). <http://fta.mofcom.gov.cn/topic/eniceland.shtml>.

While economic development remains the focus and primary objective of China's national policy, PTAs also serve as an important

* Many PTAs negotiated by China are not comprehensive, meaning provisions on trade in goods, services, and investment are not all included or are signed separately. The 20 bilateral PTAs negotiated by the United States, such as those with Chile, Costa Rica, Singapore, and South Korea, differ markedly from the 11 negotiated by China. U.S. agreements tend to cover more product categories and are negotiated from the start with as comprehensive a list as possible. China's PTAs have a narrower scope with fewer product categories.

diplomatic tool and a means to expand regional influence and secure resources. The recently signed PTA with Iceland, for example, was not exclusively motivated by the reduction of barriers to trade but was likely a strategic move by Beijing to advance its access to Arctic shipping routes between China and Europe.¹⁸⁷ Other PTAs currently under negotiation demonstrate Beijing's desire to secure natural resources, especially oil, which is not abundant domestically. China is strategically advancing its domestic agenda by negotiating trade agreements with oil-rich countries such as Norway and international organizations such as the Gulf Cooperation Council, an economic union of oil-rich Arab nations.¹⁸⁸

On a multilateral level, the United States and China have diverging and competing trade initiatives, each of which excludes the other. The U.S.-led Trans-Pacific Partnership is a free trade agreement among 12 Pacific Rim countries. The Trans-Pacific Partnership is based on the principles of "open regionalism,"¹⁸⁹ meaning that any Asia-Pacific country, including China, is welcome to apply on the condition that other parties to the agreement agree that it made a credible commitment to meet the high standards of the agreement.* The second, the China-supported Regional Comprehensive Economic Partnership, is an initiative to link Association of Southeast Asian Nations (ASEAN) member states and its free trade agreement partners. The Regional Comprehensive Economic Partnership includes China and multiple countries concurrently participating in the U.S.-backed Trans-Pacific Partnership negotiations, such as Australia, Japan, and New Zealand.¹⁹⁰

Negotiations on the Regional Comprehensive Economic Partnership began in early 2013 and are to conclude by the end of 2015.¹⁹¹ If realized, the agreement would create the world's largest group of trading partners, accounting for about half of the global market and about a third of the world's economic output.¹⁹² The Regional Comprehensive Economic Partnership has been seen as a move to counteract the U.S.'s high-profile involvement and promotion of the Trans-Pacific Partnership regional trade agreement, which has been interpreted by the PRC as a strategy to reduce China's economic influence in the Asia-Pacific region.¹⁹³ Furthermore, Beijing is leading its own regional trade agenda in Asia through the China–South Korea, China–Australia, China–India, and the trilateral China–Japan–South Korea negotiations, ultimately seeking to construct a regional web of its own free trade agreements and establish an independent ring of influence.¹⁹⁴

*At the 2011 Asia-Pacific Economic Cooperation (APEC) summit meeting in Honolulu, Hawaii, the leaders of the (then) nine Trans-Pacific Partnership countries agreed to the broad outlines of the agreement. In their statement, they envisaged the Trans-Pacific Partnership as a "living agreement," meaning that it will be open to addressing new issues as they evolve, and permit new members to join if they are willing to sign up to its commitments. See Office of the U.S. Trade Representative, "Trans-Pacific Partnership (TPP) Trade Ministers' Report to Leaders" (Washington, DC: November 12, 2011). <http://www.ustr.gov/about-us/press-office/press-releases/2011/november/trans-pacific-partnership-tpp-trade-ministers%E2%80%99-re>. The process by which new members are added has not been formalized. The aspiring candidates have followed a process agreed to by current members informally, with each aspiring candidate being approved with the consensus of the other parties. In practice, the aspiring participant must not only agree to full trade liberalization but must also demonstrate a genuine willingness to negotiate on issues sensitive to others and to commit to a high-standard agreement overall. See Ian F. Ferguson et al., *The Trans-Pacific Partnership Negotiations and Issues for Congress* (Washington, DC: Congressional Research Service, August 21, 2013).

Doing Business in China—Investment and Antitrust Challenges

Investment

China continues to adopt measures designed to encourage FDI into the country even as FDI into China dropped from a record \$116 billion in 2011 to \$111.7 billion in 2012. In the first half of 2013, FDI into China recovered slightly to \$62 billion.^{195,196} Declining optimism about the returns on investment results from China's slowing growth rate, rising labor costs, and regulatory conflicts. Among the major impediments cited by American-based multinationals operating in China are the government's favoritism toward Chinese SOEs and private domestic firms, restrictions on foreign ownership; a lack of regulatory transparency; inequity in licensing processes; increased pressure to transfer technology; weak intellectual property protection; an unreliable legal system; and corruption on the part of government officials.^{197,198}

FDI has shown signs of recovering in 2013 and was up 4.9 percent to \$62 billion in the first half of the year.^{199,200} Beijing's current, targeted efforts to bolster FDI are consistent with its history of relying on a set of measures, including investment catalogues and tax policy, to guide FDI inflows in accordance with development priorities set by the CCP. China's *12th Five-Year Plan for Foreign Capital Utilization and Overseas Investment* seeks to attract higher-quality foreign investment in designated strategic emerging industries.* The Plan also encourages multinational corporations to establish regional headquarters and centers for research and development, procurement, and financial management in China. It also indicates that China will open a variety of sectors to foreign investors.²⁰¹ In November 2012, Beijing announced plans to simplify procedures for FDI, "including new rules under which investors will not require approval for opening foreign currency accounts or for reinvesting foreign exchange earnings."²⁰² Beijing is also considering suspending FDI-related laws and regulations in newly proposed free-trade zones[†] in order to encourage investments by foreign companies and joint ventures between foreign and Chinese companies.^{203,204} Nevertheless, concerns persist, particularly amid high-profile Chinese antitrust and corruption investigations, which have implicated a growing list of foreign firms.

China Targets Foreign Firms with its Antimonopoly Law

In July 2008, China enacted its Antimonopoly Law. Three agencies ‡ evaluate effects on competition in the marketplace, as well as national security ramifications of corporate practices, and other issues relevant to China's economic development. MOFCOM is au-

*There are seven strategic emerging industries designated in the 12th Five-Year Plan (2011–2015): (1) energy saving and environmental protection; (2) next-generation information technology; (3) biotechnology; (4) high-end equipment manufacturing; (5) new energy; (6) new materials; and (7) new energy vehicles. Strategic emerging industries benefit from preferential policies and funding.

† On July 3, 2013, the State Council approved the establishment of a free-trade zone in Shanghai, "more akin to a free-market zone subject to less regulation and interference than an area of duty-free trade." Bloomberg, "China to Ease Foreign Investment Rules for New Free Trade Zones," August 17, 2013.

‡ MOFCOM, NDRC, and the State Administration for Industry and Commerce.

thorized to handle merger clearances; NDRC to handle cartels and pricing conduct; and the State Administration for Industry and Commerce (SAIC) has authority over abuse of dominance and other non-price-related, anticompetitive conduct. Until recently, however, only MOFCOM was actively engaged in Anti-Monopoly Law investigation and enforcement activities. In the five years since the law came into effect, MOFCOM has reviewed approximately 650 mergers and acquisitions, while NDRC has concluded about 30 cases, and SAIC has handled only 12.²⁰⁵

In recent months, the NDRC has stepped up investigations of foreign companies suspected of price fixing, particularly the pharmaceutical and milk powder industries. The milk powder investigations culminated with the issuance of record fines totaling \$109 million in August 2013, after companies admitted to entering into contracts with distributors to set a minimum sales price for milk powder.^{206,207} U.S.-based Mead Johnson Nutrition was issued the largest fine, RMB 204 million (\$33 million) or 4 percent of the company's total revenue in 2012.²⁰⁸ The NDRC's antimonopoly bureau chief, Xu Kunlin, told China Central Television in August that the petroleum, telecommunications, banking, and auto industries could be next.²⁰⁹ The State Administration for Industry and Commerce is also stepping up its investigative efforts. As of August 15, it is separately investigating claims of bribery, fraud, and anticompetitive behavior in the pharmaceutical industry.²¹⁰

Although both domestic and foreign firms have been targeted in these investigations, there has been speculation that Beijing is specifically targeting multinationals either in reaction to recent antitrust cases penalizing Chinese companies overseas or as a means of protecting domestic industry.^{* 211} This speculation was bolstered by revelations that at a July 2013 Antimonopoly Law training session, NDRC officials pressured some 30 foreign firms to confess antitrust violations and advised them against hiring outside counsel to defend them in investigations.²¹²

The broad scope of the new Antimonopoly Law makes it difficult for foreign companies to determine whether they are breaking the law. On July 31, 2013, Maureen Ohlhausen, head of the U.S. Federal Trade Commission, told a Beijing audience that she hoped Chinese competition authorities would move to "promote predictability, fairness and transparency."²¹³

Protecting Business Abroad—Chinese Corporate Litigation in International and Foreign Domestic Courts

Beijing has long encouraged domestic enterprises to learn to defend themselves in foreign markets. Under the Regulations on Responding to Antidumping Suits (2001), the government also authorized the Ministry of Foreign Trade and Economic Cooperation (now a division of the Ministry of Commerce) to coordinate companies' legal activities in order to ensure that individual cases are harmonized with national trade policies and objectives.^{214,215} Over the last decade, China has increasingly initiated cases in international

* In March 2013, for instance, a U.S. federal district court found North China Pharmaceutical Group and its affiliate firm to have violated U.S. antitrust law by colluding to raise prices on vitamin C exports to the United States. The Chinese plaintiffs were fined \$162 million.

courts as a means of pursuing and defending its trade and economic interests and, in recent months, there has also been a surge in Chinese corporate litigation in international and foreign domestic courts, backed by official actions and statements of support.

Bringing legal challenges directly is a means for Chinese companies to assert influence over foreign economic policies and practices in forums not designed for state-vs.-state litigation. The idea that corporate litigation can influence trade and investment relationships is not novel, but Beijing's increasing use of such litigation suggests a strategic policy that will play an important role in China's relations with its trading partners. It also has potentially significant implications for China's use of trade and investment agreements.

In 2012, in concert with Chinese government actions at the WTO, Chinese companies successfully used European courts to challenge and overturn CV and AD duties.* Speaking to the press about the 2012 legal victory of Aokang Shoes in overturning duties levied by the European Union, a spokesman for the Chinese Ministry of Commerce said it "boosted the confidence of Chinese companies in protecting their interests through legal action."²¹⁶ *China Daily* cited the victory in a call for Chinese companies to take "bolder moves to defend themselves through legal means;" and China Central Television featured a panel discussion of how the case could serve as an example for dealing with international economic challenges.²¹⁷ Chinese companies are also employing this strategy in the United States, as exemplified by the GPX Tire cases brought in U.S. federal courts last year, which supplemented Beijing's WTO actions, though less successfully.†

Chinese companies are also beginning to bring investment-related claims, both in foreign domestic courts and at the International Center for the Settlement of Investment Disputes. In foreign domestic courts, these companies are questioning other nations' assertions of what constitutes a national security issue and challenging the legality and constitutionality of other countries' domestic applications of their own laws. Ralls Corporation, for example, launched a precedent-setting challenge to the Committee on Foreign Investment in the United States (CFIUS), constitutional

* In late 2012, Aokang Shoes, the largest private Chinese shoe manufacturer, won a major victory when the European Court of Justice overturned duties that the European Union had levied on imported Chinese leather shoes in 2006. In July 2012, Zhejiang Xinan Chemical Company, a manufacturer of the herbicide glyphosate, also won a landmark victory at the same court on similar grounds. Both companies' cases coincided closely with related WTO challenges brought by the Chinese government.

† In December 2011, the U.S. Court of Appeals for the Federal Circuit ruled that the Department of Commerce had incorrectly applied double remedies against imported tires from China's GPX International Tire Co., because statutory and case law both dictated that countervailing duties could not be applied to nonmarket economy countries. (See 1984, 1988, and 1994 amendments to the United States Tariff Act of 1930. See also *Georgetown Steel Corp. v. United States*, 801 F.2d 1308, Fed. Cir. 1986, where the court concluded that countervailing duties could not be applied to nonmarket economy countries because such duties are applied in response to subsidies; a subsidy is a financial contribution by a government that distorts a market; and there can be no finding of a subsidy where there is not a market to distort). This landmark decision threw a host of open countervailing duty investigations into limbo. Fearing that the ruling had encouraged Chinese challenges of the application of countervailing duties on a host of products, the U.S. Congress adopted a legislative fix in the form of Public Law 112-99. This legislation, signed into law on March 13, 2012, amended the Tariff Act of 1930 such that the Department of Commerce was required to apply countervailing duties to nonmarket economy countries where it found subsidies, and made this requirement retroactively applicable to "all proceedings initiated ... on or after November 20, 2006."

due process claim, in response to President Obama's executive order that it divest its investment in an Oregon wind farm.*

At the International Center for the Settlement of Investment Disputes, Chinese companies are employing novel and more expansive interpretations of the investor protection clauses in their bilateral investment treaties. For example, China's second-largest insurer, Ping An, is currently pursuing a \$2.28 billion claim at the International Court for the Settlement of Investment Disputes against the government of Belgium, arguing that Belgium violated the investor protections in the China-Belgium BIT. Though China is one of the world's most prolific BIT negotiators, historically, its agreements have been geared toward managing foreign investment within China and have provided only narrow investor protections in order to protect Beijing's sovereign authority. However, in both the Ping An case and a prior one, *Tza Yup Shum v. The Republic of Peru* (2011), Chinese companies have asserted broader interpretations of investor protection clauses in existing Chinese BITs in order to protect their investments abroad.†

From Beijing's perspective, these private corporate actions may be a necessary part of a defensive strategy abroad. According to Pu Lingchen, a partner at one of the Chinese law firms that represented Aokang Shoes in its European court cases, "Without effective legal challenges against [foreign countries'] administrative measures, the often erroneously-applied legal articles used to defeat Chinese companies will be taken as precedent in future cases," and this will encourage other foreign markets to follow suit, attacking Chinese products and companies without fear of retaliation.²¹⁸ The upshot of this new trend in Chinese corporate litigation is that it indicates a growing reliance on the rule of law. This is good because, as one *Economist* article succinctly points out, the alternative to reliance on the law "would likely be escalating retaliations unrestrained by rules."²¹⁹ But the trend of Chinese corporate plaintiffs directly litigating disputes with foreign governments also suggests a diminishing willingness to rely on the dispute resolution mechanisms offered by international legal regimes, which is not promising for the navigability of the future international legal landscape.

Implications for the United States

China's failure to rebalance its economy harms the United States in two ways. China's emphasis on fixed investment has created overcapacity in many industries, such as steelmaking, which has depressed world prices and caused unemployment in the United States and other developed countries where subsidies to industry

* Ralls Corporation, a U.S. subsidiary of one of China's largest private enterprises, filed suit in U.S. district court in October 2012, presenting a precedent-setting constitutional challenge to CFIUS and the U.S. president. The suit was filed after the president issued an executive order that halted the company's planned construction of four wind farms in Oregon. The U.S. District Court for the District of Columbia dismissed the last remaining claim in October 2013, but Ralls is appealing the Court's decision. Earlier in 2012, Chinese-owned Shanghai Pengxin won a protracted legal challenge to its efforts to acquire a group of bankrupt New Zealand dairy farms, prevailing over contentions that the acquisition might pose a threat to New Zealand's strategic national resources.

† In *Tza Yup Shum v. The Republic of Peru* (2011), Mr. Tza successfully contended that the Peruvian regulators had violated Peruvian law and the China-Peru Bilateral Investment Treaty in their treatment of his investment.

are few. Privately owned companies cannot compete on a commercial basis against Chinese state-owned and state-subsidized companies exporting goods at below the cost of production. China's resistance to imports and foreign investment in its financial and services sector, and its reliance on exports to fuel economic growth, has helped to create an enormous trade imbalance with the United States. China's share of U.S. exports is rising slowly, benefitting a few industries, such as carmakers and soybean growers. And yet, the world's second-largest economy accounted for just 7 percent of total U.S. exports in 2012, a reflection of China's discriminatory market. The cumulative U.S. trade deficit with China since 1979 has risen to more than \$3 trillion, reducing employment in the United States. This trade surplus represents a claim on the productive assets of the United States.

The ASEAN-led Regional Comprehensive Economic Partnership, supported by China, has been seen as a move to counteract the U.S. promotion of the Trans-Pacific Partnership regional trade agreement. The Trans-Pacific Partnership, in turn, has been interpreted by the PRC as a strategy to reduce China's economic influence in the Asia-Pacific region. Concurrent negotiation of two competing Asia-Pacific trade pacts may lead to disunion among ASEAN member states and serve as a point of contention between the United States and China as both countries seek to establish economic and political influence over the region.

The Chinese government's attitude toward foreign investment creates an uncertain environment for U.S. firms. On the one hand, in light of slowing economic growth, Beijing has undertaken steps to reinvigorate foreign investment flows. On the other, recent government actions appear to unfairly single out foreign companies for scrutiny in bribery and pricing investigations and enforcement of the Anti-Monopoly Law.

In July 2013, Chinese regulators launched a series of antibribery and antimonopoly probes into foreign and domestic firms. The probes began with an NDRC-led antibribery probe into British multinational pharmaceutical firm GlaxoSmithKline.²²⁰ Subsequently, numerous antibribery and antimonopoly investigations were conducted on foreign firms. China fined six manufacturers of baby formula more than \$100 million for price-fixing, among them New Zealand's Fonterra, the world's largest dairy company.²²¹ Critics have argued that targeting foreign companies is merely a convenient scapegoat for the government, which is eager to assuage consumers who are upset about high prices and questionable safety of food and medicine products.²²²

While Chinese BITs have traditionally focused on protecting China from foreign litigants, Chinese companies' increasing reliance on international and foreign domestic courts to pursue and protect investment interests abroad suggests a shift toward a more aggressive use of investment treaties. Chinese corporate litigants can also be expected to directly pursue grievances against U.S. trade policies in U.S. courts with increasing frequency, just as they are doing in other jurisdictions around the world.

Conclusions

- China underwent a once-a-decade leadership change with a new president and premier and several new members of the Politburo and Standing Committee. The leadership indicated that China's overall economic policy goal—to transition from an export and investment-led growth model to a greater reliance on domestic consumption, remained the same. In reality, this change proved difficult to implement by a new government concerned about a slowing economy, real estate speculation, stagnating wages, and unemployment. The incoming government issued statements supporting a large and powerful state-owned sector in the economy, disappointing advocates of a larger private sector.
- The new Chinese leadership introduced initiatives aimed at reducing inequality, cracking down on corruption, and promoting urbanization. There are significant impediments to the government's ability to implement these reforms. For example, corruption is endemic at all levels of government, while local governments oppose urbanization due to fear that they will be overwhelmed by a flood of new migrants.
- China's progress in external rebalancing following the financial crisis was only temporary and largely driven by a weak global demand that reduced the relative size of China's export sector. Trade data for 2012–13 show that Chinese exports are again growing at a higher rate than imports, signaling a continued reliance on exports to fuel economic growth and a reversal in reducing China's massive trade surplus. As a result of failed measures to rebalance its economy, China has continued to expand its already record foreign currency reserves, reaching \$3.66 trillion by the end of September 2013.
- China's trade surplus with the United States in goods in 2012 was \$315 billion, a record. For the first seven months of 2013, China's trade surplus with the United States was \$178 billion, also a record. China continues to manipulate the value of its currency, the RMB, to achieve a competitive advantage with the United States. China also continues to follow mercantilist policies to foster a trade surplus with the United States.
- China has had little success transitioning toward a consumption-led growth model and reducing its reliance on massive infrastructure projects to boost economic growth. Consequently, China's high investment levels have led to overcapacity in multiple industries, including steelmaking, shipbuilding, and solar panel manufacturing. A slowdown in urban household disposable income growth and an increase in the household savings rate have cut into consumer purchasing power and contributed to a decline in total retail sales growth.
- Chinese officials have played down the significance of lower growth, saying the slowdown is partly due to economic rebalancing. However, the government continues to stimulate the economy through a variety of small steps. For example, the State Council, China's cabinet, instituted a temporary tax cut (scrapping all value-added and operating taxes) for more than 6 million

small- and medium-sized enterprises; reduced approval procedures and administrative costs for exporting companies; and provided more investment in railway construction in China's central and western regions. In a similar vein, securities regulators and the central bank issued record amounts of investment approvals to the Qualified Foreign Institutional Investors program.

- Due to its restrictive monetary policy, China's central bank has accumulated the world's largest foreign exchange reserves. The bulk of these reserves are invested in U.S. Treasury securities, so that Chinese ownership accounts for nearly one-quarter of foreign-owned U.S. Treasuries. In addition, China's two largest sovereign wealth funds, China Investment Corporation and SAFE Investment Company, have expanded their equity and real estate investments in the United States.
- The PRC has concluded 13 trade agreements, the latest with Iceland and Switzerland this year—the first signed with European governments. China is in the process of negotiating six additional trade agreements, which include the ASEAN-led Regional Comprehensive Economic Partnership, an initiative to link ASEAN member states and preferential trade agreement partners to form the world's largest trading bloc. The Regional Comprehensive Economic Partnership, which excludes the United States, is competing with the U.S.-led Trans-Pacific Partnership, which excludes China. Formal negotiations of the Regional Comprehensive Economic Partnership began in May 2013 and are scheduled to conclude by the end of 2015.
- China's attempts to keep the value of the RMB artificially low while strictly limiting the flow of RMB from the country, coupled with its efforts to control a large state banking sector, led to a banking crisis. The collapse in liquidity threatened economic growth in China and demonstrated the difficulty of conducting a monetary policy so at odds with its trading partners and international norms.
- The fifth round of the U.S.-China Strategic and Economic dialogue was held on July 10–11, 2013, in Washington, DC. There were no significant achievements in the strategic track. On the economic front, the most relevant announcements were (1) resumption of bilateral investment treaty talks; (2) the launch of the Shanghai Free Trade Zone; and (3) new measures to liberalize China's financial sector. In the multilateral arena, the United States successfully challenged China's improper imposition of antidumping and countervailing duties at the WTO.
- China continues to take incremental steps toward RMB internationalization, but the goal of making the RMB a major international currency remains out of reach as the government continues to maintain strict controls on cross-border capital flows.
- Beijing's efforts to reform the financial system continue to be hampered by risky off-balance-sheet lending by banks and nonbank financial institutions. Beijing has undertaken efforts to curb these risky lending practices, removing the floor on lending rates and imposing a short-term credit crunch in a clumsy effort

to send a strong signal to the financial sector. However, there is little evidence so far that these efforts have succeeded. The ceiling on rates paid to depositors remains low, and some risky lending actually increased during the credit crunch.

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SECTION 2: TRENDS IN CHINESE INVESTMENT IN THE UNITED STATES

Introduction

China has amassed the world's largest trove of dollar-denominated assets. Although the true composition of China's foreign exchange reserves, valued at \$3.66 trillion, is a state secret, outside observers estimate that about 70 percent is in dollars.* China's concentration on accumulating dollar-denominated assets is unusual for another reason: China's government has deliberately adopted a conservative investment strategy, even accepting low or negative returns on its holdings.

In recent years, China has become less risk averse and more willing to invest directly in U.S. land, factories, and businesses. This trend appears to be accelerating. In June 2013, China announced its largest purchase of a U.S. asset to date: a \$7.1 billion acquisition of Virginia-based Smithfield Foods, Inc. Given China's large holdings of U.S. dollars, China has a huge potential for foreign direct investment (FDI),† particularly if China should substitute or abandon portfolio investment for direct investment.

This section, which draws on the Commission's May 9, 2013, public hearing, continues the Commission's assessment of Chinese investment in the United States. It examines the motives and incentives driving Chinese investment, and the sectoral and geographical distribution of Chinese investment in the United States. The section also examines the mechanisms to screen and monitor such investments for threats to national security. Finally, it evaluates the proposals for reforming such mechanisms and amending them to include a net economic benefit test.

* Official U.S. government figures show that China holds \$1.28 trillion in U.S. Treasuries, making China the largest foreign holder of U.S. Treasury securities. This figure does not include holdings of U.S. agency or corporate debt nor does it reveal China's purchases of U.S. Treasury securities on the secondary market or through foreign exchanges. U.S. Department of the Treasury, "Major Foreign Holders of Treasury Securities" (Washington, DC: September 17, 2013). <http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt>.

† FDI is investment to acquire a "long-term relationship and reflecting a lasting interest and control" in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. There are two types of FDI: inward FDI and outward FDI, resulting in a *net FDI inflow* (positive or negative) and stock of FDI, which is the cumulative number for a given period. FDI excludes most portfolio investment, which is usually investment through the purchase of shares of an insufficient number to allow control of the company or its board of directors. A foreign direct investor may acquire voting power or control of an enterprise through several methods: by incorporating a wholly owned subsidiary or company (e.g., a "greenfield" investment); by acquiring shares in an associated enterprise; through a merger or an acquisition of an unrelated enterprise; or by participating in an equity joint venture with another investor or enterprise. For more information, see UNCTAD [United Nations Conference on Trade and Development], *World Investment Report 2010: Investing in a Low Carbon Economy* (Methodological Note) (New York and Geneva: United Nations, 2010); and World Bank, "Foreign Direct Investment." <http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD>.

China's National Outward Direct Investment Strategy

While the Chinese government has been encouraging large amounts of inward FDI to foster domestic economic growth for decades, policies supporting outward FDI have only recently been put in place.¹ The Chinese government explicitly adopted a policy encouraging Chinese companies to invest abroad in its 10th Five-Year Plan (2001–2005).² The “go out” policy became one of China’s main development strategies and has focused largely on Chinese state-owned enterprises (SOEs). According to Derek Scissors, then-senior research fellow at The Heritage Foundation, state-owned and state-controlled entities dominate China’s global outward FDI: From 2005 to 2012, SOEs accounted for 86 percent of total outward investment, and private entities accounted for 14 percent.³

The 12th Five-Year Plan (2011–2016) accelerated China’s “go out” strategy by calling for a three-pronged approach. First, competitive Chinese manufacturing companies should invest overseas in order to establish international sales networks and globally recognized brand names. Second, Chinese companies should invest in research and development (R&D) outside China. Finally, the plan set goals for shifting acquisitions from sectors that support resource-intensive and polluting manufacturing in favor of services and those sectors that promote a cleaner, high-tech economy.⁴

The “go out” policy focused China’s outward investment goals on sectors in which domestic state-owned or state-controlled firms were already intended to be dominant by policy (the so-called “strategic and heavyweight industries”), such as energy, machinery, construction, and information technology (IT).⁵ The 12th Five-Year Plan expanded this list with the Strategic Emerging Industries, which the government has selected for special promotion and support. The seven Strategic Emerging Industries are energy conservation/environmental protection, next-generation IT, biotechnology, high-end equipment manufacturing, new energy, new materials (raw materials), and new energy automobiles. As part of its “go out” strategy, the Chinese government has developed specific investment funds to promote outward investment in natural resources and in fields with technological promise.⁶

According to the 12th Five-Year Plan, the contribution of the Strategic Emerging Industries to China’s gross domestic product (GDP) is to grow from roughly 3 percent in 2010 to 8 percent by 2015 and 15 percent by 2020. The government promised to offer financial support, promote technical innovation and education policies, and to create a market environment to facilitate the development of the Strategic Emerging Industries.* With this change, China’s outward FDI has expanded from securing natural resources to include helping Chinese companies “upgrade their technology, pursue higher levels of the value chain previously conceded to foreign firms, and augment managerial skills and staffing to remain globally competitive.”⁷

*For background on the 12th Five-Year Plan generally, and the “Strategic and Emerging Industries” specifically, see U.S.-China Economic and Security Review Commission, *2011 Annual Report to Congress* (Washington, DC: U.S. Government Printing Office, 2011), chapter 1, section 4. <http://www.uscc.gov/content/2011-annual-report-congress>.

Another important goal of Chinese outward FDI is creation and promotion of globally competitive brands. With some notable exceptions (such as technology firm Lenovo, telecommunications giant Huawei Technology Co. Ltd., and Haier Group, a home appliance and consumer electronics manufacturer), Chinese companies have stumbled in efforts to build home-grown brands that have global recognition. The alternative strategy for many Chinese companies looking to create global reputations has come to mean buying strong brands abroad that already have marketing power rather than attempting to build Chinese brands and businesses.⁸ The aim is to create multinational companies through acquisition, particularly in the areas that are critical to China's economic development goals.⁹ Finally, investment can be a crucial tool of soft power and may be used by the Chinese government to link financial incentives to meeting political goals or simply to burnish China's image abroad.

The Chinese government wields many tools to encourage and guide investment to favored companies or industries. Overseas investments by Chinese firms require permission from the government, because the country controls capital movements across its borders, and such clearances are easier to receive if the investment is in the area favored by the Chinese government, such as food, technology, and natural resources.¹⁰ Favored industries also enjoy preferential access to financing and other benefits, making them more likely to have incentives and opportunities to go abroad. These more indirect policies are highly effective. For example, many Chinese investments in the United States reflect the Strategic Emerging Industries mentioned in the latest Five-Year Plan. In addition, evidence is growing that the Chinese government is using or sanctioning use of cyber espionage against private enterprises to give companies in favored industries a competitive edge. (For more on China's use of cyberespionage in general, and industrial espionage in particular, see chap. 2, sec. 2, of this Report.)

Patterns of Chinese Investment in the United States

In contrast to China's large holdings of portfolio investment, China is still a relative newcomer when it comes to FDI. According to official statistics from the U.S. Bureau of Economic Analysis (BEA), in 2012, the United States attracted \$174.7 billion of global FDI, of which \$219 million came from China. For 2011, BEA estimates that flows of Chinese FDI were valued at \$576 million (with FDI stock* of \$3.8 billion). A better estimate—by country of ultimate beneficiary owner—put stock of Chinese FDI in the United States at \$9.5 billion at the end of 2011.† For the same year, China's Ministry of Commerce (MOFCOM) estimates the flows of Chinese FDI to the United States at \$1.8 billion, with stock of FDI es-

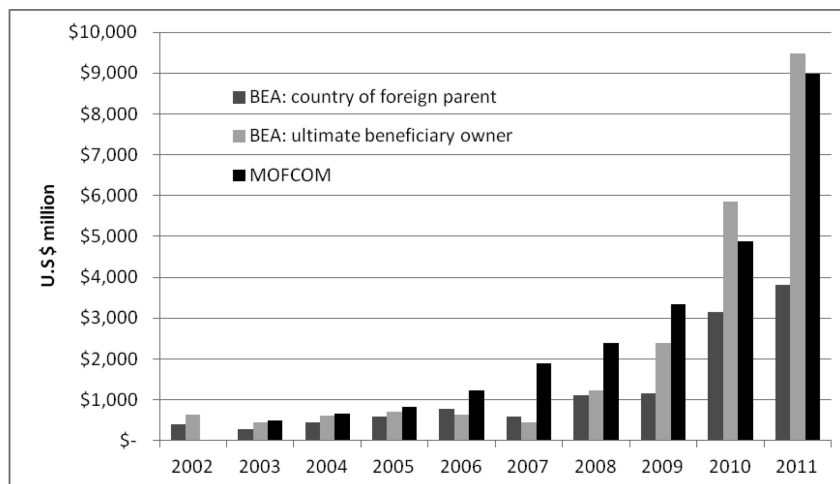
* FDI stock is the cumulative value of the capital and reserves attributable to the parent enterprise (the investor). FDI flows comprise capital provided by a foreign direct investor to an FDI enterprise, or capital received from an FDI enterprise by a foreign direct investor (these data are commonly compiled for a given period, usually per annum). For details, see UNCTAD, *World Investment Report 2010: Investing in a Low Carbon Economy* "Methodological Note" (New York and Geneva: United Nations, 2010). http://www.unctad.org/en/docs/wir2010meth_en.pdf.

† Unlike the standard reporting method, which attributes each investment to the direct purchaser of record, the method known as "country of ultimate beneficiary owner" tracks the investment to the actual owner.

timated at around \$9 billion. Despite a sustained upward trend (see figure 1), Chinese FDI accounts for less than 2 percent of total FDI in the United States.

Whether one uses the U.S. or Chinese figures, the official estimates are too low (for example, just adding together the value of the deals publicly announced in 2012, exceeds the U.S. government's estimates for cumulative Chinese investment). One key reason is that the estimates do not account for flows of FDI through Hong Kong and other offshore financial centers, such as the Cayman Islands, which are likely transit points for Chinese money on the way to the real investment destination. Private estimates of Chinese FDI in the United States provide more up-to-date information but also vary depending on the methodology used.* Dr. Scissors estimates that in 2012, China invested over \$14 billion in the United States, with cumulative FDI between 2005 and 2012 reaching \$54.2 billion. According to estimates by the Rhodium Group, in 2012 Chinese firms invested \$6.7 billion, for a total of \$23.1 billion between 2000 and 2012.

Figure 1: Chinese FDI Stock in the United States, 2002–2011



Source: U.S. Bureau of Economic Analysis; China MOFCOM, various years.

At the Commission's May 9, 2013, hearing, witnesses suggested a variety of reasons for Chinese FDI into the United States. According to Thilo Hanemann, research director of the Rhodium Group, the recent increase in Chinese FDI in the United States is

*The International Trade Administration (ITA), a bureau within the U.S. Department of Commerce, stated in a 2013 report on Chinese FDI in the United States that it is "important to be aware of different estimates" of Chinese investment. ITA noted that private sector valuations employ different definitions of FDI, data gathering mechanisms, and accounting methods that lead to differences in reported value of investments. See International Trade Administration, *Report: Foreign Direct Investment (FDI) in the United States from China and Hong Kong SAR* (Washington, DC: July 17, 2013). Private sector estimates help bridge a gap that currently exists in classifying FDI by ownership (for example, private vs. state-owned investor), as the U.S. Department of Commerce is unable to report on company-level data for FDI in the United States. BEA, which prepares the U.S. international transactions accounts, is required by law to keep such company-level data confidential.

driven by changing policies and commercial considerations. On the policy side, Beijing has become increasingly aware of the “strategic vulnerability” of having most of its foreign exchange reserves invested in low-interest-bearing U.S. Treasury securities and is looking to diversify its investments. On the economic side, U.S. leadership in technology and services has made the United States an attractive prospect for Chinese investors seeking to “increase their competitiveness at home and preserve access to U.S. customers abroad.”¹¹ Mr. Hanemann noted that a related trend is growing investment in R&D and modern service operations such as customer service and retail: “Those investments complement the acquisition of advanced manufacturing assets and allow Chinese firms to tap into the U.S. talent base and move closer to their U.S. customers.”¹²

Dr. Scissors concurred that the United States is an attractive destination for any investment, including Chinese investment, by virtue of its abundant land and energy assets, technology, and skilled labor. But Dr. Scissors has identified a more strategic dimension behind the interest of the Chinese government in foreign investment:

There is almost surely a plan behind Chinese investment, both globally and in the U.S. state-owned enterprises dominate outward investment volume, making it feasible to have a coordinated strategy beyond simply seeking demand or higher financial return. More specifically, Beijing has repeatedly indicated that ownership of overseas commodities is a valuable means of ensuring the continuous imports the [Chinese] economy so badly needs.¹³

Andrew Szamosszegi of Capital Trade Inc. concluded in his testimony that Chinese investment in the United States was motivated both by market forces and by government policies and guidance, focusing, in particular, on the Chinese government’s role as a “gate-keeper” in the investment approval process.¹⁴ Mr. Szamosszegi also pointed out that a minor motivating factor may be the desire by private Chinese firms that have difficulty raising capital in China (because state-owned banks tend to favor SOEs) to come to the United States to take advantage of the U.S. stock exchanges. From 2007 to 2011, more Chinese firms entered U.S. capital markets through the purchase of listed U.S. shell companies, a technique known as a “reverse merger,” than through initial public offerings (IPOs) by a ratio of three to one.¹⁵ (See chap. 1, sec. 3, of this Report for fuller treatment of the reverse merger issue.)

Distribution of Investment by Sector and Ownership

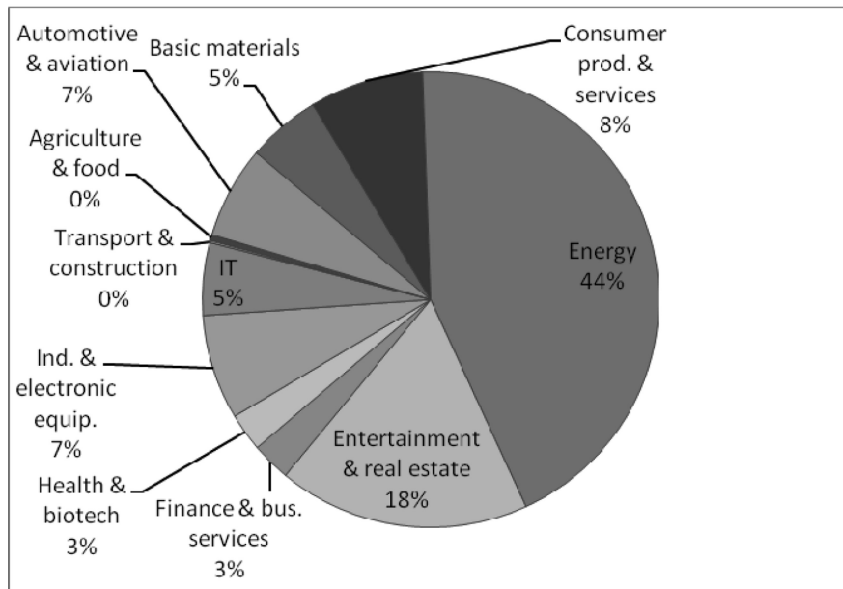
In the United States, Chinese investments have emphasized services, energy, and technology and are also notable for their focus on brand acquisition. Examples include Lenovo’s purchase of IBM’s personal computer division, and a purchase by a unit of China Aviation Industry Corp., a state-run company, of Cirrus Industries, a Minnesota-based company famous for its very light jet aircraft.

Though Chinese FDI in the United States comes in a variety of shapes and sizes, by value, it is dominated by SOEs that closely follow the industrial policies of the Chinese government and that

tend to make far larger investments. Private investors, which Rhodium defines as having 20 percent or less government ownership, are more likely to be involved in smaller deals. According to Rhodium estimates, in the years between 2000 and 2012, state-owned companies concluded 149 deals valued at over \$12.6 billion, while private companies made 444 deals, valued at \$10 billion.

Energy and services have been primary targets for Chinese investors. Chinese FDI in the energy sector is dominated by a few major deals by state-owned energy giants, as they pursue know-how and technology such as fracking, which China lacks (see figure 2). Chinese energy majors have been particularly active in the last five years. In January 2012, Sinopec paid \$2.5 billion to Devon Energy (of Oklahoma City) for a stake in about 1.3 million acres of drilling property in Michigan, Ohio, and elsewhere. In February 2013, Chesapeake Energy Corp. sold a stake to Sinopec for \$1 billion in an oil and natural-gas field straddling the Oklahoma and Kansas border. In 2010 and 2011, China National Offshore Oil Corporation (CNOOC) bought stakes in Chesapeake’s oil and gas shale assets in south Texas for \$1.08 billion and in Colorado and Wyoming for \$570 million, respectively.

Figure 2: Cumulative Chinese FDI in the United States, by Sector, 2000–2013Q2
(total deal value \$27.9 billion)



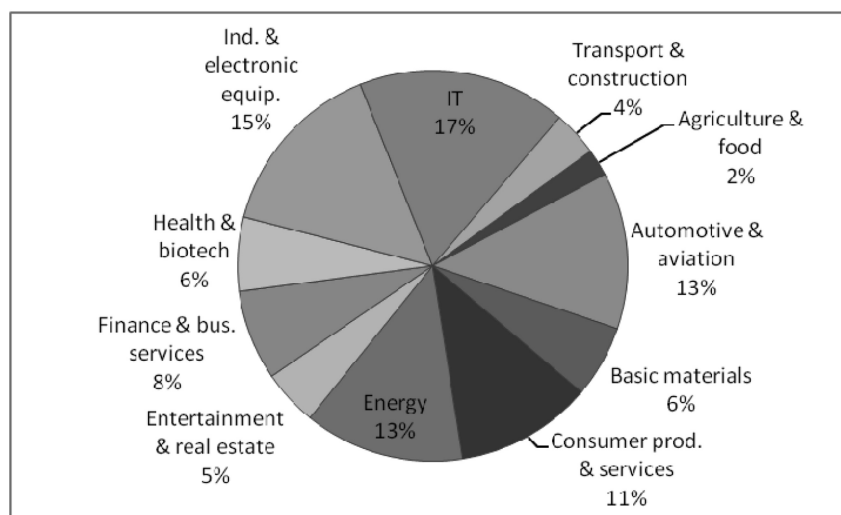
Source: Rhodium Group, *China Investment Monitor* (New York, NY: 2013).

Services are also playing a major role, accounting for over a quarter of China’s outward FDI value in the United States. In this segment, a burgeoning industry is real estate, which is favored by many Chinese investors as a more secure investment than Chinese equities. Last year’s purchases included major investments in U.S. cities, especially San Francisco, where China’s largest developer,

China Vanke Co., partnered with Tishman Speyer Properties, a U.S. real estate business, to build a \$620 million apartment complex downtown. (Under the deal, Vanke provides 70 percent equity, and Tishman is responsible for the construction.)

High-tech manufacturing is another important component of China's investments, particularly when measured in terms of the number rather than the value of deals. Industries such as IT and industrial equipment take top positions, reflecting Chinese interest in U.S. technology (see figure 3).

Figure 3: Cumulative Chinese FDI in the United States, by Sector, 2000-2013Q2
(670 deals total)



Source: Rhodium Group, *China Investment Monitor* (New York, NY: 2013).

To date, the largest Chinese acquisition in the United States has been the 2013 Shuanghui International Holding Ltd.'s \$7.1 billion bid (including debt assumption) for Virginia-based Smithfield Foods Inc., the biggest U.S. pork producer. Smithfield and Shuanghui submitted the deal voluntarily for review by the Committee on Foreign Investment in the United States (CFIUS), and it was cleared in early September 2013, according to the companies (Smithfield shareholders approved the deal on September 24, 2013).¹⁶ The agricultural sector has not been an important target for Chinese FDI in the United States so far, but it is a part of a broader trend of Chinese global investment in farm assets or food technologies.¹⁷ China's acquisitions in agriculture and other sectors are being driven by the desire to secure higher volumes of safe products and, in the long term, access to advanced production and processing technologies. (For a discussion of China's food security concerns and agricultural policy, see chap. 1, sec. 4, of this Report.)

Chinese FDI is present in most U.S. states, but states with certain industry clusters, such as oil, gas, and automotive, stand out among Chinese investors. According to Mr. Hanemann, California

is by far the number one destination for Chinese investment by the number of deals, with over 170 transactions between 2000 and 2012, or roughly one-quarter of all Chinese FDI in the United States. Other top recipients by the number of deals are New York, Texas, Illinois, and Michigan. These five states account for 352 deals out of 620 concluded between 2000 and 2012. By value of deals, New York, Texas, and Virginia lead, followed by California.¹⁸

China's attempts to diversify its investment away from U.S. Treasury bonds are also evident in its investments in U.S. private equity. For example, the State Administration of Foreign Exchange (SAFE), which manages China's foreign exchange holdings, has set up a New York operation to invest in private equity, real estate, and other assets.* Unlike China Investment Corporation (CIC), China's less publicity-shy sovereign wealth fund, SAFE has been very secretive, so little is known about the nature and magnitude of SAFE's deals.¹⁹ SAFE has been active in buying United Kingdom (UK) property and infrastructure and Japanese equities, according to some analysts. Dr. Scissors estimates that SAFE's non-bond investments in the United States total \$4.5 billion, mostly in private equity funds and similar investments. For example, in 2011, SAFE invested \$500 million in a real estate private equity fund managed by the Blackstone Group.²⁰

Economic Security Issues Related to Chinese Investment in the United States

The potential economic benefits of investment are well known: job creation, expansion of the tax base, and improvement in productivity and overall competitiveness. This is especially the case for "greenfield" investments (i.e. investments in which entirely new factories or businesses are created). Mergers and acquisitions also can generate or save jobs if the new investors revitalize ailing firms or expand local capacities. An investment in the United States made by a Chinese company on market-based terms free from strategic considerations or political interference has the potential for providing the same benefits made by any other purely economic investor.

But as is evident from the figures, Chinese investment in the United States is more often than not undertaken with a nod to Chinese industrial policy goals, such as the acquisition of valuable technology to enhance China's carefully chosen Strategic Emerging Industries (for example, Chinese investments in U.S. battery and solar technology). When such investments are made by Chinese companies owned or controlled by the government, they attract extra scrutiny for their apparent policy goals.

* In addition to SAFE, another Chinese investment entity, China Investment Federation, established an office in the Trump Building in Manhattan. The group was started in the summer of 2012 with the aim of helping Chinese investors overcome cultural, political, and logistical hurdles to doing business in the United States. It is sponsored by DKI Capital, a Beijing-based investment firm. Lingling Wei and Carolyn Cui, "China is Seeking U.S. Assets," *Wall Street Journal*, May 20, 2013; Bloomberg, "China Said to Study U.S. Property Investments with Reserves," May 27, 2013. <http://www.bloomberg.com/news/2013-05-27/china-said-to-study-investing-reserves-in-u-s-property-market.html>; and William Alden, "A Toehold for China on Wall Street," *New York Times*, May 17, 2013. <http://dealbook.nytimes.com/2013/05/17/a-toehold-for-china-on-wall-street/?partner=bloomberg>.

Experts testifying at the Commission's May 9 hearing agreed that the issue of the Chinese government's role in promoting foreign investment was further complicated by the difficulty in separating truly private Chinese companies from those under government influence or control. For example, if a private company in China sees that the government favors investment in a certain industry, it will try to invest in that industry to curry favor and take advantage of subsidies provided by the government. Mr. Szamosszegi said that "it would be the same as if the government had said . . . 'we want you to invest a lot and we want you to invest in the U.S. industry.'"²¹ Dr. Scissors pointed out that for private firms in China "there is no rule of law; there is no right of refusal for private firms" to reject government pressure to make an investment.²²

Furthermore, even genuinely private companies benefit from a slew of local and provincial government subsidies, creating an uneven playing field for their foreign competitors. A recent study by Usha and George Haley, U.S. researchers on China's economy, found that Chinese steel, glass, paper, and auto parts producers turned into global players with the benefit of local subsidies.²³ Another study, by Matthew Forney and Laila Khawaja from Fathom China, a research consultancy, found that most non-state-owned Chinese companies received some form of direct subsidy.²⁴

Witnesses at the Commission's hearing pointed out that U.S. trade laws may not be sufficient to address negative aspects of state-driven Chinese investment. For example, when a U.S. firm has to obtain credit at market rates to finance its activities, but a Chinese firm can obtain financing at minimal or even zero interest from Chinese state-owned banks, it distorts competition in the U.S. market. According to Elizabeth J. Drake, partner at Stewart and Stewart, current U.S. law does not adequately protect U.S. workers and firms from this type of unfair competition. She noted:

Existing antitrust rules, for example, are based on assumptions about the profit-maximizing behavior of market actors that simply may not apply to certain Chinese firms. In the area of predatory pricing, the U.S. applies a recoupment test, under which pricing is only deemed anticompetitive if the predator is likely to eventually collect enough profits to make up for the losses caused by the predatory behavior. . . . A Chinese SOE, by contrast, may be able to rely on state support to maintain losses that may never be recouped, and engage in predatory pricing in order to gain U.S. market share in the furtherance of political or industrial policy goals. Such a firm could engage in predatory pricing behavior that causes severe damage to its U.S. competitors, but, under current law, such behavior would not be considered anticompetitive as long as the Chinese firm was not expected to recoup its losses.²⁵

Mr. Szamosszegi and Ms. Drake noted that one motivation for Chinese investment may be to access markets that are otherwise restricted by trade barriers such as tariffs or duties imposed to counteract unfair trade practices, such as antidumping and coun-

tervailing duties.²⁶ Chinese producers are currently subject to 121 antidumping and countervailing duty orders. According to Mr. Szamoszegi, some Chinese firms have sought to avoid the duty orders by shipping to the United States illegally through third markets, while other Chinese firms from the steel, aluminum, and solar panel industries have attempted to invest in the United States to avoid existing trade remedy orders or to preempt an investigation.

National Security Issues Related to Chinese Investment in the United States

Trade-related aspects of foreign investments may intersect with national security concerns. For example, foreign intelligence collection efforts and espionage that target U.S. technology, intellectual property, trade secrets, and other proprietary information can be concealed under the seemingly benign pretext of foreign investment in cleared government contractors. In order to protect classified national security information, the federal government created the National Industrial Security Program (NISP), a program administered by the U.S. Defense Security Service on behalf of the U.S. Department of Defense and 25 other government agencies. This program seeks to prevent unauthorized disclosure of classified information, and to mitigate the threat posed by companies determined to be under foreign ownership, control, or influence (FOCI).^{*} The Defense Security Service can mitigate some dangers of such foreign investment using a specialized set of methods, which vary from case to case (for example, altering the terms of the deal or board membership).²⁷

There may be gaps, however, in the ability of the Defense Security Service to identify and mitigate FOCI. Approximately 75 percent of NISP companies are privately held and are not required to disclose their ownership or investor information to an independent regulatory agency such as the Securities and Exchange Commission. When a company enters the NISP, it must fill out a special form,²⁸ and the Defense Security Service then attempts to verify this self-reported information. Such verification efforts are often hampered by limited resources and the lack of disclosure requirements to an independent regulatory agency. Furthermore, a foreign entity could be the primary investor in a U.S. private equity fund with ownership in a company in the NISP without this potential influence ever being disclosed. Such indirect ownership further complicates analysis of possible foreign influence.

The Committee on Foreign Investment in the United States

The United States has a limited FDI screening process. CFIUS is an interagency committee that reviews certain mergers, acquisitions, and takeovers of U.S. businesses by foreign persons, corporations, or governments for national security risks. Submitting the

^{*}A company is considered to be operating under FOCI whenever a foreign interest has the power, direct or indirect, whether or not exercised, and whether or not exercisable, to direct or decide matters affecting the management or operations of that company in a manner that may result in unauthorized access to classified information or may adversely affect the performance of classified contracts. Defense Security Service, "Foreign Ownership, Control or Influence (FOCI)" (Quantico, VA). http://www.dss.mil/isp/foci/foci_info.html.

details of an acquisition for national security review is voluntary, but CFIUS can also initiate an investigation on its own after a merger or acquisition of a U.S. company by a foreigner. CFIUS can demand that the deal be unwound or restructured on national security grounds if a deal is considered a security risk, even after the deal has been completed.

There is no definition of national security in the CFIUS legislation, which allows some discretion in initiating a review process. Screening only applies to potential mergers and acquisitions and does not extend to greenfield investments (i.e. a foreign entity is establishing a company or affiliate where none exists). CFIUS also does not assess economic costs or benefits to the United States of any given acquisition. Several other countries, including Canada, Australia, France, and China have screening programs similar to CFIUS that also apply a net economic benefit test.

Among other things, CFIUS considers two elements when evaluating whether an investment by a foreign entity warrants an investigation: the degree of foreign state control, and whether the transaction could affect U.S. national security.²⁹ For China, the question of state control can be particularly complicated, because the government's role is not always straightforward or even disclosed. Despite economic reforms and moves toward privatization, large swathes of the Chinese economy remain under control by various parts of the Chinese government.³⁰

In addition to outright ownership or control, the Chinese government or the Chinese Communist Party (CCP) can also control a publicly traded corporation by influencing the composition of corporate boards and the corporation's management team.³¹ Finally, it remains debatable whether privately held Chinese corporations, especially in industries the government deems critical, such as the Strategic Emerging Industries, are free of state control or influence. For example, a report by the House Intelligence Committee flagged Chinese telecommunications-equipment makers Huawei and ZTE for potentially providing opportunities for Chinese intelligence services to tamper with U.S. telecommunications networks.³²

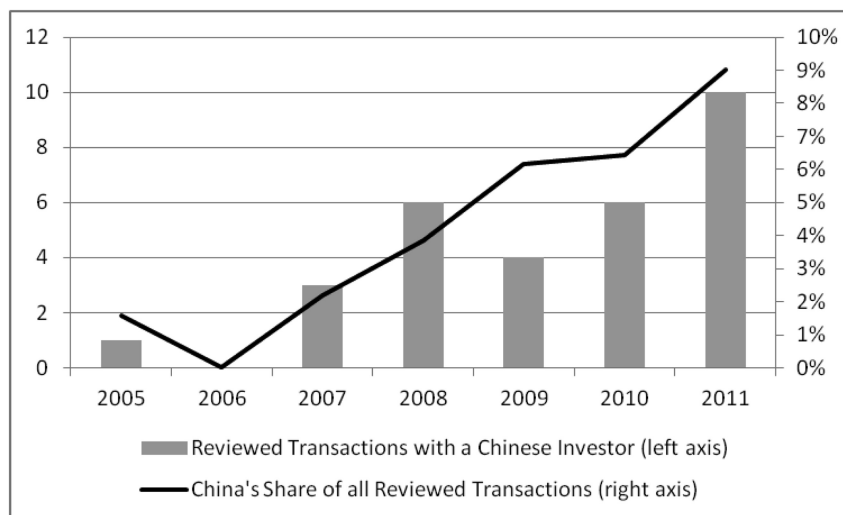
Chinese managers often complain that their firms face discrimination from regulators in the West. For example, Gao Xiqing, vice chairman of CIC, complained during a visit to Washington in April 2013 that his fund was being "singled out as a different investor" by the U.S. authorities, going as far as to say that certain people were "slapping [us] in the face and telling [us], OK, we don't like you."³³

The perceived bias against Chinese investment has been caused by a few failed deals and largely precipitated by Chinese investors' confusion over U.S. regulatory structures. In China, deals are approved in a centralized, top-down process, but in the United States, the control and regulation of foreign investment are decentralized. Federal regulations are largely responsible for vetting deals on national security grounds, with local governments, private individuals, labor unions, nongovernmental organizations, and Congressional leaders weighing in on various aspects of the deal. Chinese investors often attribute the derailment of a deal due to political or activist opposition to purposeful discrimination by the U.S. gov-

ernment against Chinese investors, but in reality it is a natural consequence of a robust democratic process. In contrast, China has several major industries, including finance, agriculture and telecommunications services, walled off from foreign investors, often as part of a policy to promote domestic companies.

U.S. regulators have blocked at least six major acquisitions from China since 2005; however, there were hundreds of projects (including deals done by CNOOC, known previously for a failed 2005 bid for Unocal) that were not rejected. Overall, despite perceptions in China, to date, the number of Chinese deals reviewed by CFIUS has been very small and those rejected even smaller (see figure 4).

Figure 4: Chinese Transactions Covered by CFIUS, 2006–2011



Source: Committee on Foreign Investment in the United States, *Annual Report to Congress* (Washington, DC: various years).

According to the 2012 CFIUS report to Congress, in 2011, out of 111 covered transactions, 10 were from China. Out of 114 planned and completed critical technology transactions in 2011, China was linked to four.³⁴ (For a list of select controversial Chinese investments, see Addendum I.)

Proposals for Amending the CFIUS Mandate

At the Commission's May 9, 2013, hearing, witnesses debated whether CFIUS should be amended to address some of the perceived gaps in the current mandate (for example, CFIUS cannot investigate and block greenfield investments, even those that might pose national security threats).^{*} Investors and analysts frequently criticize CFIUS for the secrecy of its reviews, the opacity of its national security criteria and decision-making process, and its limited scope.

^{*}There appear to be no federal laws or screening mechanisms that empower the federal authorities to evaluate whether a greenfield investment may pose a national security threat.

To address some of these concerns, Dr. Scissors proposed that CFIUS develop a very narrow definition of national security, which would make the reviews more predictable and make it easier to understand CFIUS's actions.³⁵ Dr. Scissors advocated expanding the CFIUS mandate to include any domestic transaction, including greenfield investments, involving a foreign entity. Under the expanded mandate proposed by Dr. Scissors, for example, CFIUS should be able to investigate equipment contracts, with a particular focus on telecom equipment in light of cybersecurity worries.³⁶ Dr. Scissors also criticized CFIUS for its extreme secrecy, arguing that a more transparent review, with both Congress and foreign investors receiving more information about transactions, would enhance the credibility and accountability of the CFIUS process.³⁷

Mark Plotkin, partner, Covington & Burling, agreed that the CFIUS review process could be made more transparent:

*CFIUS today will not even acknowledge that it is reviewing a ticket or transaction if asked. I do think it is important for the public to know that CFIUS is reviewing transactions. . . . The regulation of CFIUS could be enhanced to provide more information to foreign investors as to what kind of issues CFIUS takes into account when CFIUS is reviewing a transaction.*³⁸

Ms. Drake proposed that the CFIUS review process be expanded to include a "net benefit test" to review "all investments that are subsidized by or owned or controlled by foreign governments. Such investment should be reviewed from the standpoint of competitive neutrality and be reviewed for their economic as well as national security implications."³⁹ In other words, under her proposed revision, CFIUS would not just screen foreign investment for national security concerns but also for any potential economic benefit or risk to the United States.

Mr. Plotkin, on the other hand, argued against an introduction of a clear definition of national security under CFIUS because it would impede CFIUS's ability to address new or emerging problems:

*That flexibility [of the definition of national security] allows the CFIUS agencies the ability to weigh and address their individual equities and mandates during the course of a CFIUS review, and it also allows CFIUS to adapt to an ever-changing threat environment. I'd like to offer two examples of that adaptability: cyber security and state-owned enterprises.*⁴⁰

Similarly, Mr. Plotkin said it would be a mistake to expand the CFIUS mandate to include a net benefit, or economic, test, because the "principles underlying an economic test are beyond the core competency of CFIUS. . . . Moreover, CFIUS operates in strict secrecy. Secrecy in the conduct of an economic benefit test risks being perceived as protectionist."⁴¹

Implications for the United States

The federal government is responsible for national security and has put in place a system to review transactions with potential se-

curity implications. China presents new challenges, because investment by SOEs can blur the line between national security and economic security. The possibility of government intent or coordinated strategy behind Chinese investments raises national security worries. Recent investments by Chinese companies in global shale oil and gas projects match Chinese government interests in acquiring relevant technologies and diversifying its energy mix. More broadly, Chinese companies' attempts to acquire technology track closely the government's plan to move up the value-added chain. There is also an inherent tension among the different levels of government in the United States regarding FDI from China. The federal government tends to be concerned with maintaining national security and protecting a rules-based, nondiscriminatory investment regime. The state governments are more concerned with local economic benefits, such as an expanded tax base and increased local employment, rather than national strategic issues, especially as job growth has stagnated.

While Chinese FDI in the United States has been quite low so far, it has substantial room to grow. The United States needs to be prepared to harness the benefits and address the problems posed by Chinese funds flowing into our economy. Though estimates vary, even the most generous assessment shows that Chinese FDI constitutes less than 2 percent of total inward direct investment coming to the United States. Chinese companies are most interested in the U.S. energy, real estate, and service sectors, particularly financial services. In energy, as in other sectors, they are pursuing technology and expertise they do not yet have.

If current trends continue, much of China's outward FDI, at least in value terms, will be made by Chinese SOEs. Chinese SOEs receive substantial benefits from the central and provincial governments, which are not available to their foreign competitors, including preferential policies and low cost of capital. These SOEs are increasingly active globally, seeking to expand China's economic reach and power around the globe. They are involved in aerospace, autos, oil, steel, telecommunications, and other industries that the Chinese government has designated as strategic. U.S. companies face an uneven playing field when competing against Chinese SOEs in the United States and in the global market while enjoying none of the benefits afforded to SOEs by the Chinese government.

Chinese investments in the United States are subject to the same set of rules and regulations as investment from other foreign countries in the areas of foreign corrupt practices, export administration, sanctions, and antitrust. If Chinese firms run afoul of these rules, they will be subject to legal sanction. But gaps exist in the U.S. government's ability to address the competitive challenges posed by SOEs.

Chinese SOEs commonly receive subsidies from central or local governments, such as low-cost loans, loan forgiveness, favorable regulatory and tax treatment, discounted land purchases, free infrastructure improvements, and such inputs as electricity or fuel at below-market rates—benefits that are not available to U.S. competitors. By contrast, U.S. affiliates in China operate at a distinct disadvantage in sectors where favored Chinese SOEs enjoy extensive government support.

When companies favored by the Chinese government invest overseas, the situation becomes more problematic. Often, Chinese SOEs do not have to worry about making a profit, because they can rely on government support. They need not worry about their fiduciary obligations to their shareholders. Instead, they are often encouraged by the government to pursue other goals. These include resource acquisition, technology transfer, and capturing market share, regardless of cost.⁴²

Furthermore, SOEs investing in the United States may engage in particular predatory or anticompetitive behavior that U.S. trade remedies cannot address. For example, an SOE exporting goods below cost to the United States can be penalized through antidumping and countervailing duty laws. Such laws, however, do not apply to goods made in the United States by a competitor subsidized by the government, a practice that could leave U.S. companies at a disadvantage at home and in third-country markets.

Conclusions

- Chinese foreign direct investment (FDI) in the United States continues to grow, though from a very low base. According to official U.S. statistics, in 2012 the United States attracted \$174.7 billion of global FDI, of which \$219 million came from China. An estimate by country of ultimate beneficiary owner, which better tracks actual investors, put stock of Chinese FDI in the United States at \$9.5 billion at the end of 2011. For the same year, China's Ministry of Commerce put the flows of Chinese FDI to the United States at \$1.8 billion, with stock of FDI estimated at around \$9 billion.
- Official statistics underestimate the true volume of Chinese investment, because they do not account for flows of FDI through Hong Kong and other offshore financial centers, which are likely transit points for Chinese money on the way to the real investment destination. Official data are also provided after a significant delay, which hinders analysis.
- To date, state-owned enterprises (SOEs) have dominated Chinese FDI in the United States measured by the value of deals, though private companies lead by the number of deals. One reason is that the biggest investments so far have been made in the oil and energy fields, which are dominated by Chinese state-owned giants.
- Chinese investors have primarily targeted those sectors where China lacks know-how and technology, particularly in the Strategic and Emerging Industries identified in the 12th Five-Year Plan. Energy and services (in particular real estate and financial services) have received the most investment. High-end manufacturing is another important destination for China's investments, particularly when measured in terms of the number rather than the value of deals.
- Due to the considerable government ownership of the Chinese economy, provision by Chinese companies of critical infrastructure to U.S. government or acquisition by Chinese companies of

U.S. firms with sensitive technology or intellectual property could be harmful to U.S. national interests. The Committee on Foreign Investment in the United States (CFIUS) investigates the national security implications of mergers and acquisitions by foreign investors of U.S. assets.

- Investigations by CFIUS and other national security review and mitigation mechanisms may be hampered by limited resources or limited statutory authority.
- Investments made by Chinese state-owned or -controlled companies can also pose economic security threats. The Chinese government provides significant financial and logistical support. This puts U.S. firms, which receive no such support, at a competitive disadvantage. When Chinese SOEs invest abroad, they do not necessarily seek profit and may instead pursue government goals such as resource acquisition or technology transfer.
- Chinese investments in the United States are subject to the same set of rules and regulations as investment from other foreign countries in the areas of foreign corrupt practices, export administration, sanctions, and antitrust. If Chinese firms run afoul of these rules, they will be subject to legal sanction. But gaps exist in the U.S. government's ability to address the competitive challenges posed by SOEs.
- In areas where there are no national security considerations, and when the investment is driven by economic rather than strategic rationale, Chinese FDI can benefit the U.S. economy through creation of jobs and other positive spillovers.

**Addendum I: Select Controversial Chinese Investments in the
United States, 1990-2013**

Year	Investor	Target	Summary
1990	China National Aero Tech (CATIC)	Mamco Manufacturing Co.	CFIUS found that the acquisition of Mamco, which manufactured machines and fabricated metal parts for aircraft, would pose national security risks. Formally blocked by presidential order.
1995	China National Non-Ferrous Metals Import & Export Corp, San Huan, Sextant	Magnequench Inc.	The initial takeover of Magnequench, producer of high-tech magnets from rare-earth minerals, by a Chinese-led consortium and the following acquisition of Ugimag Inc. in 2000, received regulatory approval from the Clinton Administration. However, the deal drew widespread criticism in the U.S public for the transfer of technology and jobs to China when the firm's facilities in the United States were shut down in 2002 and 2006, respectively.
1999	China Ocean Shipping (Group) Company (COSCO)	Long-term lease of former Naval Base, Long Beach, CA*	Congress banned COSCO from leasing a formal naval base in Long Beach through a provision in the 1998-1999 defense authorization bill. Legislators cited national security concerns as a reason for blocking the deal through ad hoc legislative action.
2005	China National Off-shore Oil Corporation (CNOOC)	Unocal Corp.	The deal was rejected by shareholders before a CFIUS determination was made. The 2005 bid attracted significant opposition from domestic interest groups and Members of Congress. After Congress threatened to enact an amendment that would have imposed significant additional costs and risks for the buyer (the Pombo Amendment: CFIUS would be prohibited from concluding its national security review of an "investment in energy assets of a United States domestic corporation by an entity owned or controlled by the government of the PRC" until after a period of 141 days—or 51 days longer than the maximum of 90 days established under the Exon-Florio Amendment), CNOOC abandoned the bid. The U.S. competitor Chevron ultimately acquired Unocal.
2005	Lenovo	IBM's personal computer division	Domestic interest groups, the security community, and Members of Congress voiced concerns after Lenovo's plans to purchase IBM's personal computer unit became public. The deal was cleared by CFIUS after the company signed extensive security agreements.

*This project is included, although a lease would technically not be counted as direct investment.

**Addendum I: Select Controversial Chinese Investments in the
United States, 1990–2013—Continued**

Year	Investor	Target	Summary
2008	Huawei, Bain Capital	3Com	CFIUS signaled a negative recommendation based on national security risks posed by the sale of network gear. Huawei and Bain Capital withdrew the bid.
2009	Northwest Non-ferrous International Investment Co.	Firstgold Corp.	CFIUS signaled a negative recommendation based on national security risks due to Firstgold's proximity to Fallon Naval Air Station, among other concerns. Northwest Nonferrous withdrew the bid.
2010	Tangshan Caofeidian Investment Co. Ltd (TCIC)	Emcore	CFIUS expressed concerns over TCIC's acquisition of Emcore, a provider of photovoltaic and fiberoptic technology. TCIC withdrew its bid.
2010	Far East Golden Resources Investment Ltd. (FEGRI)	Nevada Gold Holdings, Inc.	After investigating the transaction in 2012, CFIUS proposed that Hybrid Kinetic Group Ltd (the ultimate controlling entity of FEGRI) divest or break up its interests in Nevada Gold as related to the Tempo mine site in north central Nevada, located in proximity to U.S. Naval Air Station Fallon. Hybrid Kinetic and its subsidiaries agreed to divest all their interests in Nevada Gold.
2011	Huawei	3Leaf	CFIUS asked Huawei to submit its purchase of assets from bankrupt 3Leaf, which created technology for cloud computing. Huawei agreed to divest its 3Leaf assets after CFIUS signaled a negative recommendation.
2012	Ralls Corp.	Terna Energy Holding USA Corp.	Ralls bought four Oregon wind farm assets without reporting the transaction to CFIUS. The U.S. Navy objected to the project's proximity to the restricted Naval Weapons Systems Training Facility airspace, where the U.S. government tests drones. CFIUS asked Ralls to submit for review; upon review, CFIUS recommended that Ralls stop operations. Ralls challenged the CFIUS determination, so the president had to formally block the deal by executive order. Ralls challenged the rejection with a lawsuit alleging that the president acted unconstitutionally.

**Addendum I: Select Controversial Chinese Investments in the
United States, 1990–2013—Continued**

Year	Investor	Target	Summary
2012	Wanxiang	A123	Wanxiang purchased the bankrupted A123 at auction for \$256.6 million, and the deal was approved by CFIUS despite significant opposition from some Members of Congress. Wanxian excluded A123's defense contracts (A123's defense division, which supplied cutting edge batteries to the U.S. military) from its bid at the auction. Those were sold separately to Illinois-based Navitas Systems for \$2.25 million. A123 has never turned a profit and received a \$249 million grant from the U.S. Department of Energy to develop lithium-ion batteries, although only about half of the money was used.
2012	CNOOC, Ltd.	Nexen Inc. (U.S. assets)	In 2012 CNOOC agreed to buy Nexen Inc. (a Canadian company) for \$15.1 billion as China's largest foreign deal. The Canadian government's Investment Canada Act was used to determine if the sale provides a "net benefit" to Canada. In December 2012, the sale was approved by the Canadian federal government. In addition to Canadian authorities, CFIUS needed to vet the deal because Nexen has U.S. interests. CFIUS approval came in February 2013.
2013	Shuanghui International Holdings Ltd.	Smithfield Foods Inc.	In June 2013, Shuanghui, China's largest meat processor, made an offer for Smithfield, the U.S.'s biggest pork producer, for \$4.7 billion in cash (including debt, the deal values Smithfield at \$7.1 billion). Smithfield and Shuanghui submitted the deal for CFIUS review, even though the food industry has not been traditionally among those relevant to national security. The proposed deal attracted opposition from some Members of Congress as well as farm, producer, consumer, and rural organizations, due to worries over food safety and the protection of U.S. technologies and intellectual property. CFIUS approved the sale in early September 2013. Smithfield shareholders approved the deal on September 24, 2013.

Source: Rhodium Group; various media reports.

ENDNOTES FOR SECTION 2

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39. U.S.-China Economic and Security Review Commission, *Hearing on Trends and Implications of Chinese Investment in the United States*, testimony of Elizabeth J. Drake, May 9, 2013.

40. U.S.-China Economic and Security Review Commission, *Hearing on Trends and Implications of Chinese Investment in the United States*, testimony of Mark E. Plotkin, May 9, 2013.

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42. U.S.-China Economic and Security Review Commission, *Hearing on Trends and Implications of Chinese Investment in the United States*, testimony of Elizabeth J. Drake, May 9, 2013.

SECTION 3: GOVERNANCE AND ACCOUNTABILITY IN CHINA'S FINANCIAL SYSTEM

Introduction

This section provides an overview of China's financial system, covering strains in the state banking system; the growth of the shadow banking sector and access to credit; market access issues and operational challenges for foreign financial services firms; and governance, transparency and accountability problems in China's financial sector. It is based on witness testimonies from the Commission's March 7, 2013, hearing; information from the Commission's fact-finding trips to China, Japan, and Taiwan; and additional staff research.

China's Banking System and Access to Credit and Capital

China's 12th Five-Year Plan (2011–2015) calls for less dependence on exports and state-funded infrastructure projects and more domestic consumption to support China's economy. This shift from government-led to private-led growth necessarily requires that Chinese families and private sector businesses have sufficient access to credit and capital. Private small- to medium-sized enterprises (SMEs) already contribute 60 percent of gross domestic product (GDP) and 80 percent of urban employment, according to some estimates.^{1,2} Yet bank lending, the traditional source of credit for entrepreneurs and startups in most countries, is largely inaccessible to Chinese individuals and SMEs, because China's financial system is dominated by large, state-owned banks that mainly service government-directed projects and state-owned enterprises. A shadow banking system of unofficial credit has sprung up to fill the gaps left by the big banks' lending practices, but it is largely unregulated, and the proliferation of shadow banking activity poses threats to the country's financial stability.*

Chinese State Banks

Chinese banks hold a unique position. "In China, banks are everything," said Carl Walter, former chief operating officer of JP Morgan China and co-author of *Red Capitalism*, at a March 7 hearing of the Commission.³ The banks provide the loans and underwrite the bonds that fund government investments in infrastruc-

*A shadow banking system is comprised of the unregulated or loosely regulated lending institutions outside the more familiar model of depository commercial banks. The shadow banking system may include loans from insurance companies, private equity firms, hedge funds, money market funds, venture capital firms, microlending, crowd sourcing, off-balance sheet lending by commercial banks, and even loan sharking.

ture and fixed assets, which have been “the major force driving China’s economic growth to near double-digit levels over the past twenty years,”⁴ he said. Banks in China are even more important to the national economy than are banks in Europe or North America, where alternative sources of financing through equity and bond markets are available even to small startups. In China, banks provide over 75 percent of the nation’s capital, according to the Financial Services Forum’s John Dearie, a Commission witness. By contrast, in most developed economies, banks are a source of less than 20 percent of capital, and in other emerging economies, banks typically provide about 50 percent of total capital.⁵

China’s financial sector is dominated by five massive, state-owned commercial banks—the Bank of China; the Industrial and Commercial Bank of China; the China Construction Bank; the Agricultural Bank of China; and, to a lesser extent, the Bank of Communications. Though they are categorized as commercial lenders, they function more as an arm of the government. The Commercial Bank Law of 1994 commercialized the operations of these banks by transforming them into retail deposit and lending institutions. The country has a network of other commercial banks, both state owned and semiprivate, which includes ten secondary shareholding commercial banks (the government holds a majority of shares in most of these), a number of city commercial banks (originally founded on the basis of urban credit cooperatives), village and township banks (the primary shareholders of which are often city commercial banks), and rural credit cooperatives.*⁶ However, as Lynette Ong of the University of Toronto explained in her testimony, the five big, state-controlled commercial banks comprise the heart of the banking system, collectively accounting for about 50 percent of all deposits and loans.⁷ In 2011, total assets of commercial banking institutions were valued at renminbi (RMB) 113.29 trillion (\$16.54 trillion), with the biggest four banks alone holding nearly 60 percent of those assets.⁸

Three policy banks were established in 1994 to take over government-directed spending functions like financing of major development projects, which were previously the purview of the newly commercialized state banks. These state-owned policy banks are the Agricultural Development Bank of China, China Development Bank, and the Export-Import Bank of China.†⁹ The Chinese Communist Party (CCP) and central government treat the policy banks as “basic utilities” that provide capital to the state sector of the economy.¹⁰ The borrowers are almost exclusively state sector entities undertaking state-directed development projects, such as the construction of dams, highways, and airports. The People’s Bank of China (PBOC), China’s central bank, sets credit quotas for the big

*The major, second-tier shareholding commercial banks include the Bank of Communications, China CITIC Bank, China Everbright Bank, Hua Xia Bank, China Minsheng Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, and Industrial Bank.

†The three policy banks—the Export-Import Bank, the Agricultural Development Bank, and the China Development Bank—were respectively charged with promoting exports, assisting with food production, and financing infrastructure projects. In the last decade, the policy banks, particularly the Export-Import Bank, have expanded their undertakings. The Export-Import Bank provides development aid and preferential loans to foreign clients purchasing certain goods and services from China and distributes government-backed loans to foreign nations. Since 2007, it has had a formal, market-oriented division.

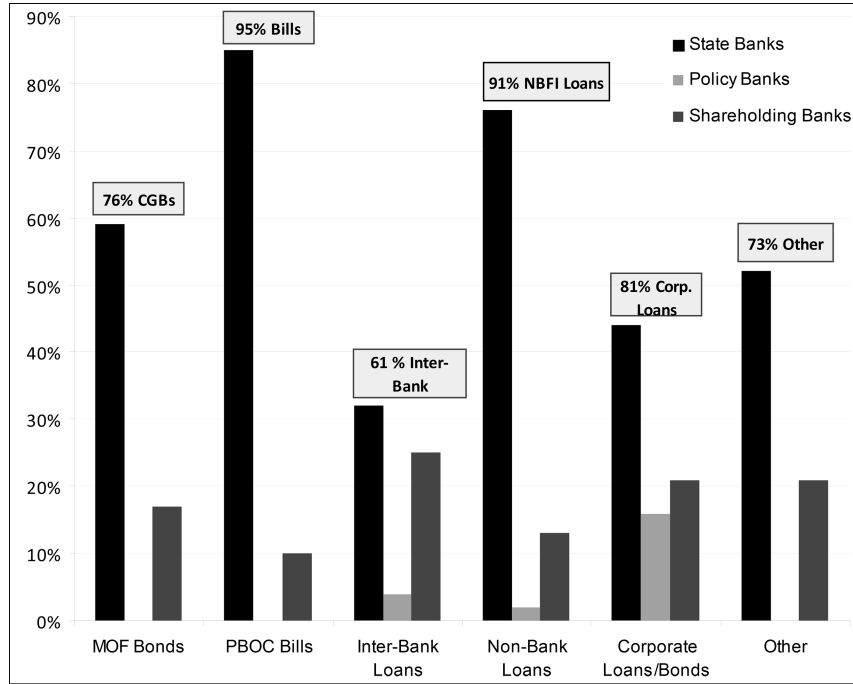
five commercial banks, and PBOC data confirm that loans made by these banks have also historically gone overwhelmingly to the state sector.¹¹

A 2013 Brookings Institution report outlines broad rationales behind the big five commercial banks' lending bias, a combination of government directives requiring them to loan to the state sector and a greater sense of confidence on their own part in the credit risks presented by state-owned enterprises (SOEs). State sector borrowers often have "strong business positions, resulting from monopolistic or oligopolistic power, superior business models or other factors;" and it seems relatively unlikely that the government will allow a large, state-owned enterprise to default on its loans.¹² On the other hand, private sector businesses are typically small, possess fewer assets that can serve as collateral, and do not enjoy the implicit backing of the government. As a result, the private sector enjoys almost no assistance from China's largest commercial lending institutions. According to an estimate by Citic Securities Co., only 3 percent of China's SMEs are able to get loans from these banks. Other estimates are even lower.¹³

The policy banks and the big commercial banks are all regulated by the China Banking Regulatory Commission. The policy banks are funded primarily by selling bonds to the big commercial banks, and all are ultimately guaranteed by the Chinese government.¹⁴ The incestuous relationship between the government; the large, state-owned policy banks; and their state-owned commercial cousins provides borrowers a considerable benefit: artificially low interest rates. PBOC sets low interest rates for depositors as well as for borrowers. Rates are approved by the State Council and the CCP's Leading Group on Finance and Banking. By controlling rates rather than allowing the market to determine them, the government ensures that the mainly state sector borrowers are able to access inexpensive capital, which in turn encourages them to borrow. The banks' depositors, meanwhile, are paid very low rates, sometimes below the rate of inflation, to help hold down the rates charged to borrowers. Thus, the state-owned corporate sector receives a subsidy from the bank's depositors (Chinese households) in the form of low interest rates. Renminbi (RMB) 36.7 trillion (\$6 trillion) of household savings are deposited into the state-owned commercial banks and receive a savings rate of only about 3 percent. Although this is higher than the average savings rate in the United States, the repressive impact on Chinese household savings is compounded by the fact that there are virtually no viable alternatives for the average Chinese person that offer higher yields.^{15,16}

Figure 1 demonstrates the outsized holdings of the large, state-owned commercial banks. Figure 2 shows shares of loans and deposits accounted for by various types of financial institutions in China, also underscoring the dominance of the five key state-owned commercial banks in China's financial system.

Figure 1: Chinese Bank Holdings of Financial Assets, Fiscal Year 2010



* CGB—Chinese Government Bonds; MOF—Ministry of Finance; NBFIs—Nonbank financial institution; PBOC—People’s Bank of China.

Source: U.S.-China Economic and Security Review Commission, *Hearing on Corporate Accountability, Access to Credit, and Access to Markets in China’s Financial System: Rules and their Ramifications for U.S. Investors*, written testimony of Carl Walter, March 7, 2013.

Figure 2: Chinese Financial Institutions by Size of Loans and Deposits, 2010

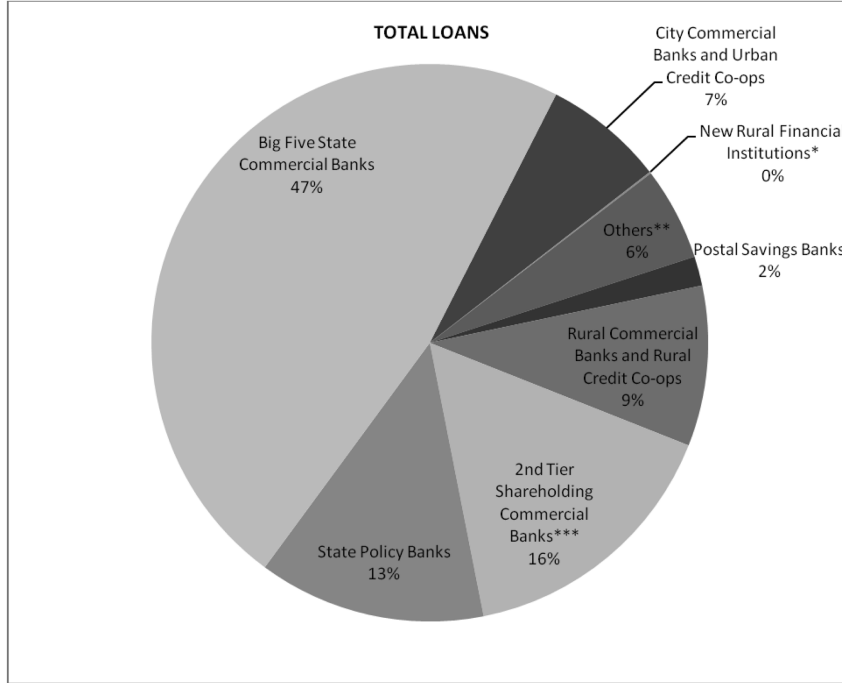
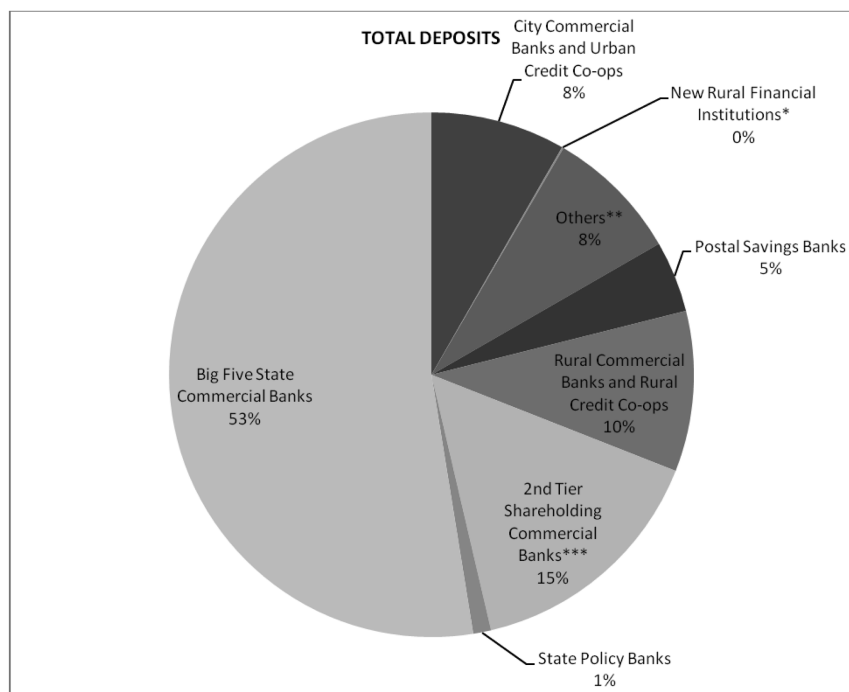


Figure 2: Chinese Financial Institutions by Size of Loans and Deposits, 2010—Continued



*New rural financial institutions include township and village banks, microcredit companies, and rural mutual aid funds.

** Others consist of nonbank finance companies and overseas banks.

*** The government owns a majority of shares in most of the second-tier shareholding commercial banks.

Source: U.S.-China Economic and Security Review Commission, *Hearing on Corporate Accountability, Access to Credit, and Access to Markets in China's Financial System: Rules and their Ramifications for U.S. Investors*, written testimony of Lynette Ong, March 7, 2013.

The Stock and Bond Markets

Shareholder rights are limited in China, and many publicly traded firms are majority owned by the government. “Lacking the ability to influence business choices and dividend levels, or to sell the firm as a whole, shareowners place less reliance on underlying firm value and focus more on likely stock price movements in the short run.”¹⁷ As a result, Chinese markets are dominated by volatile speculative trading, and are often compared to casinos. The two Mainland stock exchanges, the Shanghai Stock Exchange and the Shenzhen Stock Exchange, have undergone significant development in recent years but are not comparable to the U.S. or European stock exchanges in scale, importance, or regulation and still largely exclude private Chinese enterprise. The Hong Kong exchange is the sixth-largest exchange globally and the most popular destination for Chinese companies seeking to list outside the Mainland, but it has a backlog of Chinese firms waiting for approval to list.¹⁸

Like the state banks, China's stock markets most reliably generate capital for the state sector.¹⁹ The Chinese government uses the domestic stock markets "to create oligopolies and monopolies—the so-called national champions—run by high-ranking political appointees," said Dr. Walter.²⁰ As with bank interest rates, the equity market system for initial public offerings (IPOs) is controlled by the government. The government "literally sets the prices of new shares based on how much funding it needs to raise, then directs other government-controlled entities to invest."²¹

Equity markets "fail to serve as a venue for capital-raising by the private entrepreneurial companies critical for the innovation and job creation that will be necessary for China's long-term economic health," Georgetown University law professor Paul Saulski told the Commission.²² An IPO is "fundamentally a bank loan from a state-controlled bank, not the result of a business owner selling a stake in his company to outside investors seeking the highest return on their capital, as we think of in the West," wrote Dr. Walter.²³

Compared to the banks, the stock markets play a less important financial role.²⁴ Chinese equity financing raised a record \$123 billion on domestic and foreign exchanges in prerecession 2007. Far larger was the \$530 billion in new loans extended by Chinese banks that year and the \$581 billion in total debt issues in the bond market.²⁵ Current imbalances are even more striking. Total debt issuance in the bond market was approximately \$1.2 trillion in 2011.²⁶ Total new loans extended by Chinese banks in 2012 were approximately \$1.1 trillion.²⁷ Meanwhile, IPO approvals ground to a virtual halt in 2012 as a result of new China Securities Regulatory Commission policies, underscoring the fact that "IPOs in China remain not a function of market dynamics, but of political and institutional policies that can change both completely and suddenly."²⁸

One means of diversifying credit risk away from the banking system is to encourage companies to raise funds by issuing bonds. China's leadership seems to have recognized the potential utility of a strong bond market and has made rapid headway in developing one. The Chinese bond market is now the world's fourth largest in terms of value. At approximately \$3.41 trillion (RMB 20.9 trillion), its size is surpassed only by the United States, Japan, and France.²⁹ It is also increasingly diverse and includes both public and private debt. But while China's bond market possesses the superficial appearance of a modern bond market, most of the bonds issued and traded are actually issued by other banks rather than corporations. The corporate bond sector was valued at only RMB 548 billion (\$89.7 billion), or less than 3 percent of the Chinese bond market's total value, as of December 2012.³⁰ China also has yet to develop a properly functioning municipal bond market, and it is only beginning to develop a market for high-yield bonds, both of which are important for attracting investment capital. In addition, Beijing restricts foreigners from investing in the bond markets.³¹

Strains on the Banking System

Because lending by the state-owned banks is based on government policy decisions rather than commercial considerations, it is

not surprising that the banks have accumulated large numbers of nonperforming loans from lending to poorly run or poorly chosen projects undertaken by SOEs.³² Chinese banks appear to be undergoing a resurgence of the self-inflicted bad debt crisis that troubled them in the late 1990s and early 2000s.³³

In 1999, the key Chinese state-owned commercial banks held roughly RMB 2.5 trillion in nonperforming loans, or 31 percent of China's annual GDP at the time. Bad loans accounted for 39 percent of Chinese banks' loans.*³⁴ China's central government created four asset management companies to bail out the banks by disposing of their loans. The government's recapitalization of the big banks between 1999 and 2005 removed RMB 3 trillion (\$400 billion) in bad loans, or 25 percent of total loans, from bank balance sheets in order to compensate for the missed loan repayments from mismanaged and unprofitable state sector projects.^{35,36} The banks' nonperforming loans were generally bought at full value by the asset management companies, paid for with ten-year bonds backed by the Ministry of Finance and loans issued to the asset management companies by China's central bank.³⁷ The central government also launched a variety of other initiatives aimed at curbing the big banks' substandard lending and maintaining asset quality. By the end of 2008, the nonperforming loan ratios of commercial banks had dropped to 2.4 percent of the total.^{38,39}

With the Chinese government's response to the global financial crisis, however, the strain of nonperforming loans has returned. Although financial statements provided by international auditing companies show the banks' current nonperforming loan ratios at less than 1 percent, this figure only covers loans that are on the balance sheets, and it strains credulity in light of the banks' central role in carrying out the government's stimulus response to the global economic crisis.⁴⁰ In November 2008, the central government announced a \$652 billion (in current dollars) stimulus, the equivalent of 12.5 percent of China's GDP that year, and directed the banks to fund the bulk of it by granting loans for infrastructure projects.⁴¹ According to analysis by KPMG, a multinational accounting firm, "Banks extended RMB 9.6 trillion worth of new loans" in 2009, "more than twice the total lending in 2008," and RMB 8.0 trillion in 2010.⁴² As the Chinese economy responded, the banks kept boosting their lending. The International Monetary Fund (IMF) estimates that Beijing has relied on the big banks to issue at least \$3.8 trillion (RMB 23.4 trillion) in new loans since 2008 to help offset the impact of the global economic crisis on the Chinese economy. Dr. Walter estimated that the unofficial shortfall "could be anywhere from \$1 trillion (RMB 6.2 trillion) to \$2.3 trillion (RMB 14.2 trillion) against bank capital of \$400 billion."⁴³ As one financial journalist noted, "Either the Chinese government has become extremely skilled at lending in a very short time, and Chi-

*By comparison, Spanish banks' bad loan ratio reached a record high of 12 percent in 2013 as a result of the recession there. The average nonperforming loan ratio for all U.S. banks between 1999 and 2009 was 1.67 percent, according to the Federal Reserve, and is currently 3.16 percent. At the height of the financial crisis, the average nonperforming loan ratio for all U.S. banks was nearly 6 percent. "Banking Brief for Pennsylvania, New Jersey and Delaware," *Philadelphia Fed*, First Quarter 2011. <http://www.philadelphiafed.org/research-and-data/publications/banking-brief/2011/BB1Q2011.pdf>; Charles Penty & Emma Ross-Thomas, "Spanish Banks' Bad Loans Ratio Climbs to Record 12.1%," *Bloomberg*, October 8, 2013. <http://www.bloomberg.com/news/2013-10-18/spanish-banks-bad-loans-ratio-climbs-to-record-12-1-.html>.

nese borrowers have become even better at repaying, or the numbers are too good to be true.”⁴⁴ Meanwhile, there are questions about whether the asset management companies (AMC) could be used to aid another bank recapitalization. Though at least two of them claim to be profitable today, other evidence strongly suggests that they are still holding a significant amount of the debt they took on in 1999. According to one unnamed financial expert who spoke to *The Economist*, they “seem to be virtual holding-tanks where the debt doesn’t stay and doesn’t depart either.” There is speculation that they are insolvent.*⁴⁵

The lending binge has raised fears of impending inflation and ushered in a clampdown on lending in 2012 and 2013, “with harsh quotas that have made credit available only to those SOEs least likely to default.”⁴⁶ For example, bank lending to local government financing vehicles has been curtailed.† Local government financing vehicles are companies set up by local governments to facilitate borrowing from state banks, which allows them to spend beyond the limits of their budgets. There are currently more than 10,000 local government financing vehicles in China. These hidden and unregulated companies have been “the unseen hand powering China’s investment-led economic growth over the past decade.”⁴⁷ Bank lending to local government financing vehicles rose from “RMB 1.7 trillion in outstanding loans at the beginning of 2008 to nearly RMB 5 trillion just two years later.”⁴⁸ In December 2012, outstanding loans to local government financing vehicles reached an estimated RMB 9.2 trillion (\$1.4 trillion). The China Banking Regulatory Commission and the Chinese Ministry of Finance began instituting limits on future issuances, first barring local governments from using public assets as loan guarantees on behalf of their financing vehicles and then announcing that new loans extended to local government financing vehicles must be covered by existing cash flows and that the projects they are used for must generate returns.⁴⁹ Approximately one-third of the outstanding loans to local government financing vehicles are scheduled to come due in the next three years, and “there are well documented concerns that many of the underlying projects offer insufficient cash generating ability to service the incumbent debt.”⁵⁰ To avoid potential defaults, banks have begun extending maturities for local governments.⁵¹

By directing the banks to extend so much cheap credit to local government financing vehicles and SOEs for state sector projects

*The four asset management companies established to dispose of the banks’ nonperforming loans are Orient AMC (which serviced the Bank of China), Great Wall AMC (which serviced the Agricultural Bank of China), Huarong AMC (which serviced the Industrial and Commercial Bank of China), and Cinda AMC (which serviced the China Construction Bank). It is not entirely clear how much the asset management companies have recovered, but in 2009 the ten-year bonds were extended an additional ten years to assist in continued recovery, indicating that the 1999 bank bailout is very much an ongoing job. As of December 2012, Orient AMC had reportedly disposed of \$37 billion of these nonperforming assets and recovered \$8 billion, achieving a cash recovery ratio of 21.90 percent. Both Huarong and Cinda claim to be making profits, but their claims are not verified.

†Local governments are not permitted to borrow directly from state banks and also are generally not permitted to issue municipal bonds under the 1995 People’s Republic of China algorithm law (Chapter 4, Article 28). Thus, in order to fund the infrastructure and development projects that the central government encouraged, local governments have used state-owned resources and assets, especially land, as collateral to set up local government financing vehicles that meet basic asset and cash flow lending requirements and then borrowed from the state banks through the local government financing vehicles.

unlikely to generate revenue in the short term, the central government has encouraged SOEs and local governments to hold too much debt, increasing the likelihood that the banks will require another government bailout or restructuring due to an accumulation of nonperforming loans and a sudden drop in profits.⁵² Despite the high ratio of outstanding bad loans to capital, however, the stability of the banks may be relatively assured in the near term because the banks are undergirded by the central government and the central bank. Dr. Walter describes the backstops in the financial system as a shell game with three shells: the government itself, the banks, and the SOEs. “You can move these bad loans anywhere you want,” he says, to ensure that the banks remain solvent.⁵³ But the central government’s effort to rein in risky bank loans has fueled a boom in unofficial credit that presents more complex problems for authorities. As the challenges of obtaining bank credit have mounted, local governments and private sector businesses have increasingly relied on alternative, less regulated, and less transparent financing channels to fund investment projects.⁵⁴ This explosion of unofficial credit complicates existing challenges for the government’s efforts to rebalance the economy and maintain financial stability.

Strains on Rural Credit Cooperatives—The Big State Banks of the Countryside

Rural credit cooperatives are locality-based credit institutions important to banking and credit in rural China. Although they account for only 10 percent of total deposits and loans nationwide, 80 percent of rural deposits and loans are made using rural credit cooperatives. They are the primary providers of credit to rural households and the primary holders of rural household savings.⁵⁵ As of 2010, the rural credit cooperative system included 2,646 rural credit cooperative county unions, 223 rural cooperative banks, and 85 rural commercial banks.⁵⁶ Rural credit cooperatives have historically been “first and foremost accountable to the party, rather than to depositors or shareholders,” and they are frequently urged to support local government enterprises and projects.⁵⁷ Since 2003, the rural credit cooperatives have been managed by provincial credit unions that report to provincial governments, but local party leaders also continue to influence loan allocations and decisions.⁵⁸

The financial performance and asset quality of rural credit cooperatives vary, but Dr. Ong notes in written testimony to the Commission that rural credit cooperatives are a longstanding weak link in China’s fiscal system, because they are perpetually “saddled with mountains of bad loans.”⁵⁹ In 2007, the PBOC provided RMB 168 billion in debt-for-bonds swaps and RMB 830 million in earmarked loans to assist rural credit cooperatives in disposing of bad assets and writing off historical losses.⁶⁰ The stability of rural credit cooperatives improved after their bailout but, like the state-owned banks, they heavily supported the 2008–2009 stimulus programs and are likely experiencing deteriorating asset values.

Although the central government is not technically under any formal obligation to ensure the stability of the rural credit cooperatives, much like the big, state commercial banks, they are treated as if they are too big to fail. Most likely this is due to the risk of

social unrest in the event of a rural financial collapse.⁶¹ Because rural credit cooperatives are locality specific, the collapse of a rural credit cooperative would be less likely to cause cross-regional economic panic and bank runs than would the collapse of one of the big state banks, but rumors of a collapse in one region could potentially incite panic and runs in another.⁶²

Shadow Banking

The “shadow banking system” can broadly be defined as lending that falls outside of the official banking system.*⁶³ It can involve both traditional and nontraditional institutions and is best understood not in terms of the institutions engaged in the system but in terms of the activities that they undertake.⁶⁴ It encompasses a “broad range of bank-like activities (often using uninsured, short-term funding) that are lightly scrutinized and only sometimes backed by private sector sources of liquidity.”⁶⁵ Since shadow banking activity occurs outside of formal banking channels, it does not appear on bank balance sheets and is far less transparent than official lending activity. Chinese shadow banking products include entrusted loans (loans made by a third party to a borrower where a bank or other financial institution serves as the intermediary), investment trusts, wealth management products, credit guarantees, trusts, money market products, and various types of microloans.⁶⁶

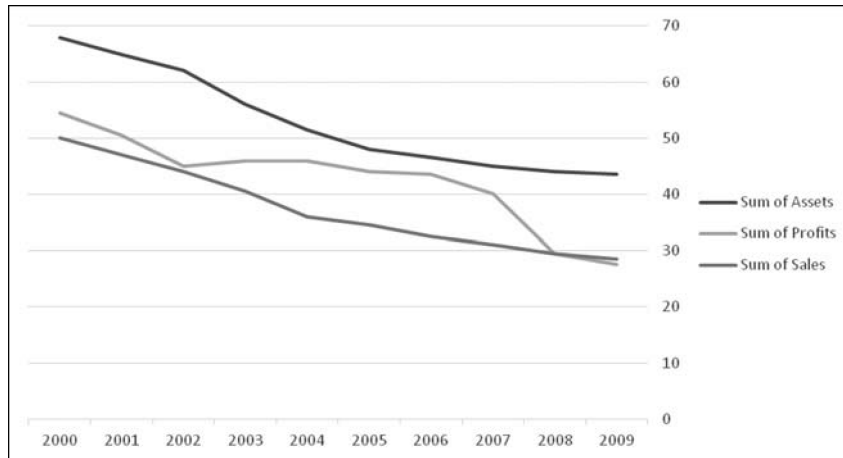
Since shadow banking is dominated by lending to higher-risk borrowers, it is frequently characterized by high fees and high interest rates.⁶⁷ Loans are often arranged by middlemen who are paid a fee, and borrowers sometimes pay interest as high as 70 percent or more per year.⁶⁸ Such high rates are charged despite the fact that the legal maximum interest rate is currently 23 percent and by law cannot exceed four times the benchmark lending rate, currently 6 percent for one-year loans.⁶⁹ Commission witness Regina Abrami, Wharton’s director of the Global Program at the Lauder Institute of International Studies and Management, points out that some non-bank-based financing in China, in the form of private money houses, pawnshops, and revolving credit associations, dates back centuries. This financing has long served much as it does today “to aid the economic transactions of firms and individuals who might not otherwise be able to obtain funding or resolve short-term liquidity crises.”⁷⁰ Chinese demand for shadow banking is largely driven by the growth of China’s private sector, a sector with limited access to official bank credit; and the Chinese government’s tolerance of shadow banking in recent years has been tied to the reality that the private sector is the increasingly dominant source of the nation’s employment. In 1980, the state sector accounted for 76.2 percent of urban employment. But by 2012, official Chinese sources attributed 80 percent of urban employment and at least 60 percent of China’s GDP to the private sector.⁷¹

*The term “shadow banking” refers to “the whole alphabet soup of levered up non-bank investment conduits, vehicles and structures” that are either unregulated or less regulated than conventional bank loans. In the prefinancial crisis U.S. context, this meant money market funds, asset-backed securities, leveraged derivative products, and other nonbank assets in the capital market that featured prominently in the U.S.’s subprime mortgage crisis. Paul A. McCulley, “Global Central Bank Focus: Teton Reflections” (PIMCO, September 2007).

According to written testimony prepared for the Commission by *Bloomberg Businessweek*'s Sheridan Prasso, 97 percent of China's 42 million privately owned SMEs are unable to obtain officially sanctioned loans from the big state banks.⁷² According to the official Xinhua news agency, 19 percent of all bank lending went to small businesses in 2011, and KPMG estimates that the size of SME lending in the banking sector may now account for as much as 25 percent of total bank lending, but "these figures are distorted by the lack of differentiation between state-owned and privately owned SMEs."⁷³ Certainly the majority of China's private sector is comprised of SMEs, many of them unregistered businesses, but there are no data on the percentage of SMEs with significant ties to the state.⁷⁴ Chinese businesses "fall into a bewildering variety of legal categories and their respective contributions to GDP are not reported in official statistics," but China's National Bureau of Statistics estimates that enterprises not majority owned by the state now account for at least two-thirds of the country's industrial output.⁷⁵

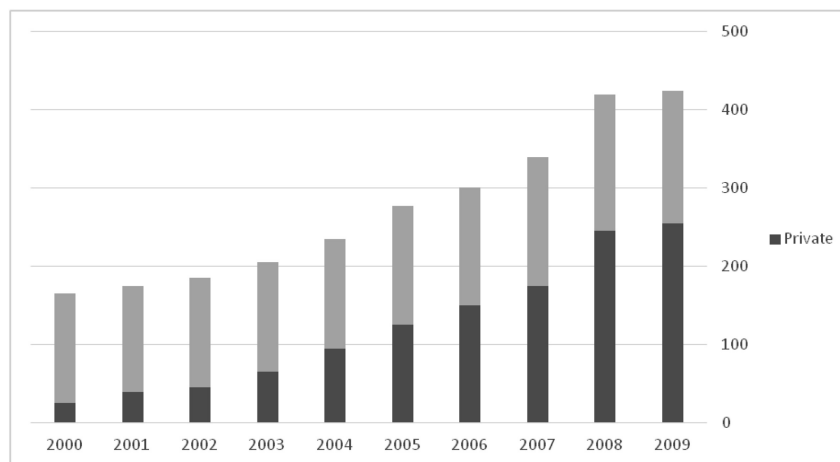
Figure 3, below, shows Chinese state-owned enterprises' declining share of industrial market. Figure 4 depicts the growing market share of private industrial enterprises with revenues exceeding RMB 5 million.

Figure 3: Chinese State-owned Enterprises' Percent Share of Industrial Assets, Sales and Profits, 2000–2009



Source: "Let a Hundred Flowers Bloom," *Economist*, March 10, 2011. <http://www.economist.com/node/18330120>, sourced from hedge fund Keywise Capital Finance.

Figure 4: Growth of Industrial Enterprises with Revenues Exceeding RMB 5 Million, 2000–2009



Source: *Economist*, “Let a Hundred Flowers Bloom,” March 10, 2011. <http://www.economist.com/node/18330120>, sourced from New York City-based research firm China Macro Finance.

Although China’s banks continue to control a significant percentage of the country’s capital, their percentage of overall lending is shrinking as the private sector grows. Commercial banks accounted for 52 percent of the country’s total financing in 2012, down from roughly 90 percent a decade ago.^{76,77} Shadow banking is filling in this gap. As a result of their limited access to official sources of credit, private sector businesses seek capital from the unofficial alternative channels in the shadow banking system. “Helping them along on the supply side,” Dr. Abrami noted, “are hundreds of millions of Chinese savers, profitable private firms, and state-owned enterprises eager to see better returns on their earnings than is possible through standard deposits within the formal banking system” or investment in the markets.⁷⁸

Successfully channeling credit to China’s productive private sector is a necessary precondition for economic rebalancing and among the biggest financial challenges facing China’s new leadership.⁷⁹ Since the government has undertaken efforts to rein in the risky bank lending that proliferated with the 2008 economic stimulus, it has permitted a boom in the shadow banking system to help maintain the country’s macroeconomic growth.⁸⁰ In addition, Chinese regulators have regarded shadow banking as “a byproduct of their attempts to unleash more market forces in the allocation of capital in China,” a useful “experiment in liberalized interest rates” and “an incubator for risk-based capital allocation and financial innovation.”^{81,82} In the meantime, the ever-tightening restrictions on access to official sources of credit have shifted more and more borrowers to shadow alternatives. Shadow banking meets important market demands, ensuring that the private sector businesses generating so many of China’s jobs are able to access credit when they need it.⁸³ The growing pool, says Dr. Abrami, has also now “moved beyond small enterprises to include larger firms, local governments

... and businesses within politically disfavored sectors, such as property development and mining,” effectively circumventing the government’s efforts to rein in lending to overdeveloped sectors.⁸⁴

No one knows with certainty the size of China’s shadow banking system but, according to Chinese Central Bank estimates and much private sector analysis, it is valued at RMB 2 trillion to 4 trillion (\$325 billion to \$630 billion), or approximately 7 percent of total lending, four times its estimated size in 2008.^{85,86} The China Banking Regulatory Commission has produced a higher estimate of RMB 7.6 trillion (\$1.2 trillion) for 2012, which is equal to 14.6 percent of China’s 2012 GDP.⁸⁷ Total off-balance-sheet banking activity in China, including “credits to property developers, local-government entities and small-and-medium size enterprises (SMEs), individuals and bridge-loan borrowers,” has been estimated as high as RMB 17 trillion as of the end of 2012, or roughly one-third of GDP.⁸⁸ Even by this largest and most expansive estimate, the shadow banking system is still smaller than China’s commercial banking industry, which had an estimated \$21 trillion in assets as of September 2012.^{89,90} And by comparison with the shadow banking systems of the West, China’s shadow banking is also relatively small. According to the Financial Stability Board, shadow banking had \$23 trillion in assets in the United States and \$22 trillion in assets in the European Union in 2012. Nevertheless, the recent exponential growth of the Chinese shadow banking sector, combined with the continued growth and increasing economic importance of the private sector relative to the state sector, is driving a “reduction in the use of the official banking system to perform basic functions of finance.”⁹¹ In some parts of China, informal lending now exceeds official bank lending.⁹²

Chinese Shadow Banking Terminology

Bank Trust Products

Bank trust products are packaged by trusts and sold by banks, frequently resulting in a lack of transparency as to whether the bank or the trust is responsible for their performance.⁹³

Entrusted Loans

Entrusted loans are products that allow banks to serve as middlemen by identifying high-net-worth individuals who can provide corporate loans. According to Bloomberg News, entrusted loans last year accounted for nearly 8 percent of the RMB 14.27 trillion (\$2.3 trillion) raised in private placements—loans and other funding sources, such as returns on stocks and bonds—compared with 0.9 percent in 2002.^{94,95}

Passageway Deals

In passageway deals, trusts and brokerages cooperate with banks to act as passive reservoirs for loans that banks originate but cannot keep on their own balance sheets without exceeding lending quotas or transgressing capital requirements or loan-to-deposit ratios. Investors who have purchased wealth manage-

Chinese Shadow Banking Terminology—Continued

ment products from the banks often bear the risk if borrowers default on the loans that the trust companies and brokerages have purchased from the banks.⁹⁶ Industry executives say at least 50 percent of trust company assets and 80 percent of brokerages' entrusted funds are related to this so-called "pas-sageway business."⁹⁷

Peer-to-Peer Lending

Peer-to-peer lending is a form of microcredit, and the companies that facilitate it online match borrowers with lenders able to offer small, short-term loans. The peer-to-peer lending market is worth approximately \$3.2 billion and is comprised of approximately 2,000 online sites.⁹⁸ Peer-to-peer loans can be as small as RMB 50. One of the better known Chinese peer-to-peer lending companies, Creditease, reports that its average loan is RMB 50,000 (\$8,200), "too small for banks but attractive to online micro-financiers."⁹⁹

Trust Companies

There are 64 Chinese trust companies today, with assets valued collectively at approximately \$1.2 trillion.¹⁰⁰ Trust companies have surpassed the insurance industry in China in terms of the value of their assets and are now second only to the banking industry.¹⁰¹ Bank of America Merrill Lynch estimates that trust companies account for 8.9 percent of all bank loans.¹⁰²

Wealth Management Products

Wealth management products are the fastest-growing investment vehicle in China. Banks funnel money deposited by savers into these riskier investments that are mostly held off of their balance sheets and sell them to support their credit growth, since wealth management products allow them to circumvent the China Banking Regulatory Commission's caps on interest rates for bank loans. These are highly nontransparent products because of a lack of disclosure requirements.¹⁰³ Total outstanding issuance of wealth management products was approximately RMB 6.7 trillion (\$1.1 trillion) in the third quarter of 2012, an increase of 47 percent from the end of 2011.¹⁰⁴ Bank of America Merrill Lynch estimates that wealth management products comprise 8 percent of all bank loans.¹⁰⁵ Fitch Ratings Agency recently estimated that these products now account for approximately 16 percent of all commercial bank deposits.¹⁰⁶ Wealth management products generally offer 4 to 5 percent yields, roughly 1 percent higher than the ceiling on deposit rates. The China Banking Regulatory Commission was initially supportive of the growth of wealth management products offered by banks, but amid recent concerns over defaults, regulators have cracked down on the practice.¹⁰⁷

Shadow Banking Risks

According to recent analysis by the Federal Reserve Bank of Dallas, "Shadow banks are [now] at the center of our global market-

based financial intermediation system, conducting maturity, liquidity, and credit transformation without explicit public sector credit guarantees or liquidity access.”¹⁰⁸ The explosion of new financing vehicles presents risks that investors may not understand and that appear to outstrip government regulatory capacities. In the aftermath of the 2008 financial crisis, there has been a push among regulators, both in the United States and abroad, to increase scrutiny of these financial intermediaries in order to reduce risks in the global financial system as well as in domestic ones.

In December 2012, the IMF released an assessment identifying shadow banking as one of the key risks to China’s continued financial stability.¹⁰⁹ According to Ms. Prasso, “The primary risk to the [Chinese] government lies in its potential inability to intervene if a large number of underground loans suddenly go bad in a crisis; there is no centralized place to put the money, as in a bank bailout.”¹¹⁰ Dr. Abrami also notes that the Chinese government may not be able to sufficiently regulate the risks posed by the rapid proliferation of private lending activities.¹¹¹

A particular cause for worry is the extent to which traditional Chinese banks may be exposed to the risks of the shadow banking system. Fitch Ratings Agency estimates that about 80 percent of new shadow banking credit is tied to the big commercial banks and that an even bigger percentage of outstanding shadow banking loans is linked to these banks.¹¹² The banks are moving undesirable assets into the shadow banking system “on an unprecedented scale, reinforcing suspicions that bank balance sheets reflect only a fraction of the actual credit risk lurking in the financial system.”¹¹³ Trust companies and brokerages are a vital source of credit for banks seeking to “arrange off-balance-sheet refinancing for maturing loans that risky borrowers cannot repay from their internal cash flow.”¹¹⁴ As the *Financial Times*’ Kate Mackenzie explains:

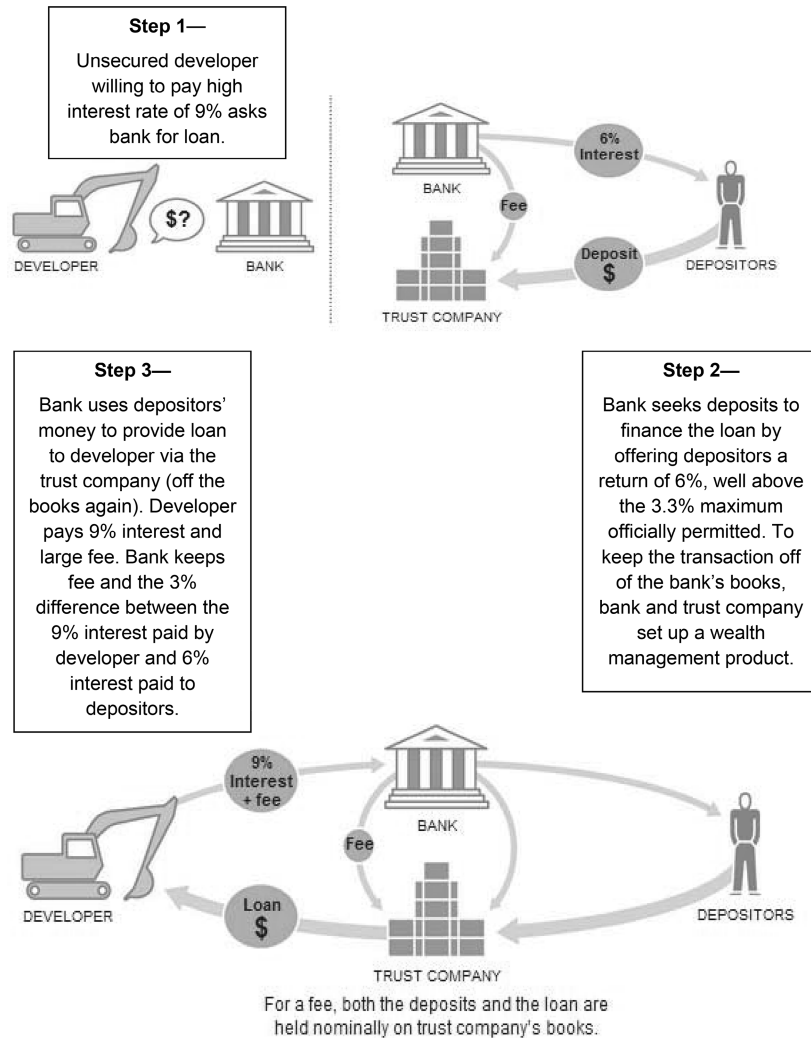
*The elephant in the room is that the shadow institutions are the co-dependent evil twins to the commercial banks . . . banks are reliant on the shadow institutions to supply their liquidity, and shadow institutions get a lot of their capital from the banks. . . . Not only does the shadow market fund the banks, but banks fund the shadow market: banks are the ultimate source of many ‘non-standard’ financial products. . . . The whole market is running on the rate arbitrage between official channels, which lend at 6.5–9.5 percent, and gray channels, which lend at 12–60 percent.*¹¹⁵

Whenever the central government eases monetary policy, the big banks tend to lend excessively, but when it tightens monetary policy, the shadow banking system steps into the gaps. With the banks so closely tied to the shadow banking system, it appears that tighter official lending rules not only fuel the growth of unofficial lending but also specifically encourage the banks to engage in more risky, less transparent lending.¹¹⁶ Banks are increasingly pressing customers to shift money from the older, regulated parts of their operations to newer, off-the-books products. “The key question is no longer how much risk banks are carrying,” but how many risky loans have been shifted to lightly regulated, shadow banking prod-

ucts offered by the banks and to “lightly regulated shadow banking institutions—mainly trust companies, brokerages and insurance companies.”¹¹⁷

Figure 5, below, illustrates one means by which banks create and issue off-balance sheet loans.

Figure 5: Example of Off-Balance Sheet Lending by Chinese Banks



Source: *The New York Times*, “Questionable Lending in China,” July 1, 2013. <http://www.nytimes.com/interactive/2013/07/02/business/Questionable-Lending-in-China.html?ref=global>. As noted in *The New York Times* article, this is but one example of how shadow banking might work.

China’s leadership is turning a sharper eye toward the risks in the shadow banking system.¹¹⁸ Regulators have, for instance, begun issuing prohibitions against certain types of lending.¹¹⁹ In

December 2012, the Ministry of Finance, the National Development Reform Commission, the People's Bank of China, and the China Banking Regulatory Commission issued a communiqué on curbing illegal financing by local governments, banning local government borrowing from individuals or nonfinancial institutions such as trust companies and fund management companies.¹²⁰ In June 2013, PBOC dramatically tightened credit in the interbank market, where banks have been lending money to each other and to large shadow financiers to fund higher-yield offerings. Despite signs of a liquidity crunch, the central bank delayed injecting more money into the markets, insisting that "overall bank liquidity conditions are at a reasonable level" and that banks should "prudently manage liquidity risks that have resulted from rapid credit expansion."¹²¹ China's official Xinhua news agency said on June 23 that the cash crunch was engineered to curb risky bank funding of shadow banking activities.¹²²

On April 26, the Chinese government announced that more than 1,400 people had been sentenced to prison terms of at least five years for illegal shadow banking activities. A total of 4,170 people have reportedly been convicted of violating shadow banking rules since 2011.¹²³ People charged in the most recent crackdown were convicted of violations such as illegal fundraising, public advertising to find lenders, and promising excessively high rates of return.*¹²⁴ Legal experts complain, however, that the central government has not sufficiently clarified what is and is not legal for lenders and borrowers. They argue that many of those netted in crackdowns and sweeps are engaged in practices that have not been explicitly prohibited.^{125,126} Another problem in cracking down on shadow banking in the absence of increased access to official lines of credit is that it threatens to starve China's entrepreneurial companies of capital, which in turn may hinder China's indigenous innovation.¹²⁷

Market Conditions and Access Issues for Banking, Investment, Insurance, and Other Services Firms

Expanding access to traditional bank lending for China's 42 million SMEs would be a key way for Beijing to allow the private sector to thrive without compromising the government's regulatory powers. U.S. financial services firms say China should provide them with greater market access and operating capacity so that they can help to develop the Chinese financial sector. They note that, in contrast with China's bank-dominated financial system, in the United States, more credit is provided by financial markets and nonbank lenders than by banks, and they argue that they offer knowledge, experience, and products that China needs.¹²⁸ Though China has taken some steps to expand foreign firms' access to its financial markets since joining the World Trade Organization (WTO) in 2001, this access remains quite limited (see *Chinese Rationales for Market Barriers* later in this section).

* China's Supreme Court website defines "illegal fundraising" as applying to individuals who receive more than RMB 200,000 (\$32,000) of informal loans or cause losses to lenders of RMB 100,000 (\$16,000) or more. "Enterprises can face charges if they receive RMB 1 million (\$160,000) or cause losses of RMB 2.5 million (\$400,000)." Joe McDonald, "China jails more than 1,400 in lending crackdown," Associated Press, April 26, 2013.

China's economy has long been heavy on manufacturing and light on services, but the services sector is growing. Manufacturing accounted for 45.3 percent of China's GDP in 2012, while the services sector (transport, wholesaling, retailing, hotels, tourism, financial services, real estate, scientific research, and other services) accounted for 44.6 percent, according to official statistics.¹²⁹ Strengthening this sector is a key goal of China's 12th Five-Year Plan for Economic and Social Development, as its expansion promises the creation of new jobs, increased domestic consumption and decreased dependence on exports and state investment projects for economic growth—all vital to the economic rebalancing needed to reduce the U.S.-China bilateral trade deficit.¹³⁰ Unfortunately, the financial services subsector has not been growing as quickly as services overall, despite the fact that the development of this subsector is particularly crucial to China's achievement of its rebalancing goals. As Mr. Dearie told the Commission, "Capital is the lifeblood of any economy's strength and well-being, enabling the investment, research, and risk-taking that fuels competition, innovation, productivity, and prosperity."¹³¹ An obvious way to increase access to capital is to spur development of the financial services sector in China. Fundamentally, the financial services sector struggles to thrive because of the extent of government intervention in the overall financial system. While the explosion of the shadow banking sector and the government's tolerance of it indicate the leadership's recognition of the need for financial liberalization, the government has been slow to embrace financial liberalization. This foot dragging continues even as the risks attendant in shadow banking underscore the importance of developing more comprehensive and well-regulated financial services than the informal shadow banking trend offers. The shortage of financial services inhibits the very consumption that China's leaders have committed to cultivate. While domestic consumption per capita continues to grow, it has actually fallen as a percentage of GDP from more than 60 percent to less than 50 percent between 2000 and 2013, and more than half of the wealth in Chinese households today is still held in the form of low interest rate savings.¹³²

Empowering the Chinese consumer requires the broad availability of financial products and services, including personal loans, credit cards, mortgages, pensions, insurance products and services, and retirement security products. This would in turn persuade Chinese citizens to reduce their precautionary savings.¹³³ U.S. financial services firms have long argued that if China would open its market to more investment, they could grow their own business. China has taken some steps to further open its financial services market in recent years. Foreign direct investment in financial services increased 122 percent between 2007 and 2010, but foreign access to China's financial markets more broadly remains heavily restricted, and this apparent high growth rate belies the fact that investment grew from a very small market share.¹³⁴ Foreign ownership in the Chinese banking system, for example, currently amounts to less than 2 percent.¹³⁵ And, according to Steve Simchak, director of International Affairs at the American Insurance Association, foreign property-casualty insurers in China cur-

rently hold only a 1.2 percent market share as a result of significant market entry barriers and a lack of national treatment.*¹³⁶

U.S. financial services companies complain that even as the United States has taken steps to allow increased Chinese access to its financial services market, China is not reciprocating. The *Wall Street Journal* reported that China's state-run Citic Securities is applying for a license with U.S. regulators, making it the latest Chinese firm to expand into the United States as the Chinese government continues to encourage its financial services companies to invest more of the nation's foreign exchange reserves in foreign markets. Yet within China, foreign banking, securities, and insurance affiliates all continue to be subject to ownership restrictions and regulatory approval processes for their investments that are far more stringent than those that apply to domestic competitors. China's minimum capital requirements for foreign banks seeking to operate in the Chinese market exceed international norms, and foreign banks also cannot open new branches without permission from regulators and face cumbersome and lengthy approval processes.¹³⁷ Foreign-owned securities and asset management firms are limited to joint ventures in which foreign ownership is capped at 49 percent, while foreign life insurance companies remain limited to 50 percent ownership in joint ventures and to 25 percent equity ownership of existing domestic companies; and, until a 2012 WTO dispute settlement panel ruling, market access for foreign electronic payment providers was virtually nonexistent.¹³⁸

In his testimony to the Commission, Professor Saulski noted that studies by the Organization for Economic Cooperation and Development and the World Bank ranked China as "one of the most restrictive markets for financial services among the G20." China is also far more restrictive than its fellow major developing economies: Brazil, Russia, and India.¹³⁹ Professor Saulski further explained that "the current lack of significant competition in China's financial sector hinders efficiency, limits investor choice, and restricts access to capital by non-state-owned firms. Furthermore, the lack of competition in China's financial markets facilitates destructive rent seeking behavior by special interest groups and well-connected individuals. In its most pernicious form, this creates a perfect environment for fraud, insider dealing, and corruption."¹⁴⁰

Chinese Rationales for Market Barriers: The General Agreement on Trade in Services (GATS) and the Global Economic Crisis

Though China's restrictions on market access to the financial services sector are significant, they are compatible with the country's 2001 WTO accession agreement, which was largely negotiated by the United States acting on behalf of other WTO members. Under the WTO's General Agreement on Trade in Services, Most Favored Nation (MFN) status and national treatment apply only as specified in a member country's schedule and MFN exemption

*National treatment is a principle of international law by which states guarantee that they will not favor their own citizens or businesses with treatment better than what they afford to those of their trading partners.

list.*¹⁴¹ WTO members are explicitly allowed to provide non-MFN treatment if they record the exemptions in their WTO schedule of services commitments, though these exceptions are subject to negotiation in future multilateral trade talks. Members also are not obligated to provide national treatment except for the service categories that they choose and only to the extent recorded in their schedule of WTO services commitments. Agreements to gradually eliminate or reduce limitations to market access are also voluntary, “applying only to those service categories included in a Member’s schedule and only to the extent specified.”¹⁴² Because many of the obligations under GATS are voluntary, most WTO members, including China, were selective about the service sector categories for which they undertook obligations in their accession agreements.¹⁴³

At the ten-year review of China’s WTO accession agreement in 2011, the United States criticized China’s lack of progress in fully implementing its financial services obligations, honing in on continued restrictions on foreign ownership of Chinese banks and insurance companies. The Office of the U.S. Trade Representative (USTR) noted in its 2012 report to Congress on China’s WTO compliance problems that “China has continued to maintain or erect restrictive or cumbersome terms of entry in some sectors.” USTR also underscored problems with “informal bans on new entry, high capital requirements, branching restrictions or restrictions taking away previously acquired market access rights.”¹⁴⁴ The Chinese claimed that their refusals to fully open the financial services sector were justified by the 2008 financial crisis, which cast developed nations’ financial systems in an unfavorable light. As a senior official at the Shanghai Stock Exchange reportedly put it in 2009, “The master has been proven to be a fool.”¹⁴⁵ Mr. Dearie noted in his testimony that a major increase in negative Chinese perceptions of the U.S. financial system due to the global economic crisis damaged the ability of U.S. financial services firms to access the Chinese market and of USTR to negotiate greater access.¹⁴⁶

In June 2010, China proposed new WTO financial services discussions aimed at examining “the gains and pains” of financial liberalization and financial regulatory practices suited to developing countries. China reportedly noted:

While many see liberalization of trade in financial services as an essential contributing factor towards the development of the sector, others regard excessive and premature liberalization of the financial sector as a key ingredient for financial instability. . . . This is a particularly relevant subject in the post-crisis era, as many countries are now concerned about how to develop their financial sector so that it generates real economic growth rather than asset bubbles. . . . There is increasing evidence that the developed Members may also have taken excessive liberalization commitments.

*Most Favored Nation treatment is a means of establishing equality of trading opportunity between states by ensuring that all nations accorded MFN status are treated equally by any given trading partner. An importing country cannot discriminate against the goods from one MFN country in favor of another MFN country’s goods. If an importing country grants any type of concession to one MFN trading partner, this concession must also be given to all other countries with MFN status.

*Before the financial crisis, deregulation was the main trend in the domestic financial market of the developed countries, and in the international arena, the developed countries pushed for more liberalization commitments to gain greater financial deregulation in the markets of their trade partners. The financial crisis has brought a sharp turn in the way we think about financial deregulation, and now the most popular word for the financial regulators is 'reregulation.'*¹⁴⁷

China also warned that foreign services firms would dominate the most profitable sectors of the Chinese market, impeding the development and success of domestic firms. In addition, China worried that foreign firms might act as conduits for household savings to be funneled out of the country rather than invested domestically and that the increased linkages with the global financial system could leave China more susceptible to volatilities in the global market.¹⁴⁸

China's Financial Sector—Foreign Investors Experience Problems with Governance, Transparency, and Accountability

Even if foreign service firms were given access to household savings in China, weak corporate governance, regulatory oversight, and accounting practices in China create problems for potential foreign investors. Investor confidence in China's securities markets and in Chinese companies trading on U.S. and other foreign exchanges is important to the Chinese government's economic rebalancing efforts. Selling shares of Chinese companies to foreign investors has become an increasingly significant means of raising capital. However, China's traditional banking system and its publicly traded corporations are hobbled by poor audit quality and unreliable financial statements. Investor confidence depends on transparent and reliable accounting and audit regimes—to which the Chinese government has shown resistance. Improvements in the governance of China's companies and its capital markets are critical to protecting American shareholders and American investments in China.

China's Corporate Governance Creates Challenges for Investors and Regulators

Demand for credit has led Chinese companies to seek capital overseas even as its shadow banking system has expanded. In the late 1990s, Chinese companies began raising capital on major international stock exchanges. This trend has been driven by large Chinese companies, many state owned, that have sought to broaden their shareholder base, increase the liquidity of their shares, and enhance the visibility of their brand names. In part, it has also been driven by small- and medium-sized private Chinese companies seeking alternative capital options beyond the state-controlled banks that dominate China's financial system, and the limited domestic exchanges.

U.S. stock markets are among the most popular alternate global exchange destinations for Chinese firms. According to Commission

witness Paul Gillis, professor at Peking University and Standing Advisory Group member of the Public Company Accounting Oversight Board (a quasi-public entity established by the Sarbanes-Oxley Act that polices auditors and reports to the U.S. Securities and Exchange Commission (SEC)), there are more than 200 Chinese companies that have offered shares of stock on the New York Stock Exchange and NASDAQ in recent years, and hundreds more have entered U.S. over-the-counter markets.¹⁴⁹ However, many of the Chinese companies listing in the United States have proved to be poor investments.

Initially, U.S. investors purchased stock in U.S.-listed Chinese companies in hopes of profiting from China's rapid growth rate. However, investors in U.S.-listed Chinese companies have increasingly found that insufficient corporate governance standards make these companies high-risk investments. Many have been implicated in frauds and accounting scandals, and U.S. regulators have deregistered about 50 Chinese companies in the past two years following fraud probes.¹⁵⁰ The stigma attached to U.S.-listed Chinese companies as a result of this regulatory scrutiny has lowered returns for nearly all of them. The 82 companies in the Bloomberg Chinese Reverse Mergers Index lost 52 percent of their market value between June 2011 and July 2012.¹⁵¹ U.S.-listed Chinese companies are "deserting U.S. stock markets in record numbers as regulatory scrutiny mounts and the advantages of a U.S. listing slip away."¹⁵² Six U.S.-listed Chinese companies announced plans to go private through buyouts in 2010, but by 2012, 27 Chinese companies had announced they would go private. In addition, approximately 50 mostly smaller U.S.-listed Chinese companies deregistered with the SEC, ending their requirements for public disclosures, in 2012.¹⁵³ In addition, far fewer Chinese companies are listing on U.S. exchanges. Only three Chinese companies successfully went public on U.S. exchanges in 2012, down from 41 in 2003.¹⁵⁴

Two types of Chinese companies in particular have sought access to U.S. capital markets: smaller enterprises with limited ability to use Chinese capital markets, and some of the largest state-owned enterprises in industries such as petroleum and telecommunications.¹⁵⁵ Larger Chinese state-owned enterprises have primarily entered the U.S. markets by openly filing IPOs on the New York Stock Exchange and NASDAQ in the form of American Depositary Receipts (ADRs) or ordinary shares.*¹⁵⁶ In 1993, state-owned Sinopec Shanghai Petrochemical was the first Chinese company to list on a U.S. exchange by issuing an IPO in the form of ADRs.^{157,158}

Smaller private Chinese companies have most commonly sought access to U.S. markets because they lack sufficient domestic sources for capital and have entered the markets by merging with existing, registered U.S. shell companies in reverse mergers. Reverse mergers do not require approval from the China Securities Regulatory Commission (the Chinese counterpart of the U.S.'s Public Company Accounting Oversight Board) and involve much less

*An ADR is a certificate representing one or more shares of a foreign firm's stock, denominated in U.S. dollars.

regulatory scrutiny by the SEC than do IPOs. A reverse merger involves a private company purchasing a publicly traded company and shifting its management into that company. This allows the private company to become publicly traded without going through the regulatory and financial disclosure processes associated with an IPO. Most Chinese reverse mergers are traded on the over-the-counter market until they satisfy various requirements, such as size and capitalization level, that qualify them to list on the New York Stock Exchange or NASDAQ. Between 2000 and 2011, approximately 443 Chinese companies entered U.S. markets via reverse mergers, but relatively few of these have made it off of the over-the-counter market and onto the New York Stock Exchange or NASDAQ.¹⁵⁹

As of May 2012, there were approximately 112 Chinese companies traded on the New York Stock Exchange or NASDAQ in the form of ADRs, 21 traded in the form of ordinary shares, and 79 that listed via reverse merger transactions.¹⁶⁰ Large Chinese companies entering U.S. markets via IPOs, including state-owned enterprises, have accounted for the greatest share of Chinese companies' market capitalization, but they have been greatly outnumbered by smaller Chinese companies entering U.S. markets via reverse mergers. This latter group has also generated a sizeable portion of Chinese companies' market capitalization. According to the Public Company Accounting Oversight Board, between January 2007 and March 2010, 159 Chinese companies entered the U.S. securities markets using reverse mergers and generated market capitalization of \$12.8 billion. In the same period, 56 Chinese companies, including a number of very large, state-owned enterprises, completed U.S. IPOs and had an aggregate market capitalization of \$27.2 billion.¹⁶¹

Chinese Reverse Mergers Skirt Oversight

Chinese reverse merger transactions have attracted the bulk of the critical attention from U.S. regulators. Companies that enter the U.S. market via reverse mergers are riskier investments, because they do not go through the disclosure processes associated with traditional IPOs and thus offer less information to investors. In response to increasing complaints involving foreign reverse mergers, the SEC issued a bulletin in June 2010 warning investors of the risks of fraud and other abuses involving reverse merger companies. The SEC also set up a task force to investigate the foreign company reverse merger trend and associated investor risks. In November 2011, the SEC approved new NASDAQ, New York Stock Exchange, and American Stock Exchange rules that impose more stringent listing requirements for reverse mergers. Under the new rules, a reverse merger company cannot apply to list on the New York Stock Exchange, NASDAQ, or the American Stock Exchange until it has completed a one-year "seasoning period" of trading on the U.S. over-the-counter market or on another regulated U.S. or foreign exchange following its reverse merger. It also must file all required reports with the SEC, including audited financial statements, and maintain a minimum share price of \$2.00 to \$4.00 for at least 30 of 60 trading days immediately prior to filing its listing application.^{162,163}

An ABC News investigation in January 2013 found that since 2010, more than 70 Chinese companies have been removed from or left NASDAQ and the New York Stock Exchange after reports of alleged fraud and financial irregularities.¹⁶⁴ In 2008 and 2009, there were very few U.S. federal securities class actions filed against companies domiciled in China. In 2010, Chinese companies were the target of 15 such suits, and by 2011, that number had risen to 38 suits—accounting for 17 percent of the 224 U.S. federal securities class actions filed in 2011 and nearly 66 percent of the 60 such suits targeting non-U.S. companies.¹⁶⁵ At least 42 of the Chinese companies targeted by U.S. securities class actions to date were listed on U.S. stock markets via reverse mergers and have been subjects of SEC investigations of financial schemes that former SEC Chairman Mary Schapiro described as “brazen.”¹⁶⁶ According to analysis by the Harvard Law School Forum on Corporate Governance and Financial Regulation, “Over 85 percent of U.S. securities class actions filed against Chinese issuers from 2008 to mid-2012 have included accounting-related allegations.”¹⁶⁷

In order to be publicly traded on the U.S. capital markets, companies have to make public certain information about their business strategies, operations, material risks, and financial results. The financial statements contained in companies’ annual reports filed with the SEC are required to have an independent external audit for consistency with U.S. accounting standards. These standards are the same for all companies notwithstanding where they are registered. In its *2010 Annual Report to Congress*, the Commission noted that SEC standards for assessing material risks may benefit from singling out certain nations for special scrutiny, based on their domestic accounting standards. For example, there is no reporting requirement that takes note of the unique and politicized role that the CCP plays in the selection of Chinese corporate leadership.

The House Financial Services Committee sent a letter to the Public Company Accounting Oversight Board and the SEC on September 9, 2010, complaining of the quality of auditing of U.S.-listed Chinese companies. The Big Four accounting firms (PricewaterhouseCoopers, KPMG, Deloitte Touche Tohmatsu, and Ernst & Young) audit 88 percent of all U.S.-listed Chinese companies, including a number of the companies named as defendants in U.S. government-filed law suits.¹⁶⁸ Public Company Accounting Oversight Board standing advisory group member and Commission witness Paul Gillis noted in a recent report that fraud and accounting issues associated with U.S.-listed Chinese companies have brought mounting pressure for these accounting firms to verify that they have conducted their audits properly.¹⁶⁹

SEC Cracks Down on Accounting Firms of Chinese Companies

During recent probes, the SEC has sought audit work papers from the accounting firms, a common request during fraud investigations. To date, the firms have refused to produce these documents, arguing that doing so would put them in violation of Chinese state secrets laws. In China, sharing accounting information with foreign regulators and removing audit papers from the coun-

try violates state secrets laws. Chinese authorities also do not permit non-Chinese regulators to conduct investigations in China.¹⁷⁰ Chinese law “prohibits firms from producing audit working papers directly to any foreign regulator and requires those foreign regulators to seek such documents through the China regulator,” according to Commission testimony by Cynthia Fornelli, executive director of the Center for Audit Quality.¹⁷¹ China has several times amended its Law on Guarding State Secrets to be more inclusive of a variety of information, including economic statistics.¹⁷² China is also applying its State Secrets Law to private companies. In the SEC’s investigation of Deloitte Touche Tohmatsu’s auditing of China-based Longtop Financial Technologies, for instance, Deloitte said Chinese regulators had warned them that turning over working papers to the SEC could lead to sentences of life imprisonment for the partners involved and to the banishment of their firm from conducting further business in China.¹⁷³ In the United States, however, withholding foreign public accounting paperwork of U.S.-traded companies violates both the Securities Exchange Act and the Sarbanes-Oxley Act, which require foreign audit firms to produce documents concerning U.S.-listed clients at the SEC’s request.¹⁷⁴

In December 2012, the SEC charged five firms with breaking U.S. securities laws by refusing to turn over the requested audit work papers. The defendants in the case are Beijing-based BDO China Dahua, Ernst & Young Hua Ming, KPMG Huazhen, Shanghai-based Deloitte Touche Tohmatsu Certified Public Accountants, and PricewaterhouseCoopers ZhongTian. China-based affiliates of these accounting firms face the possibility of losing both their right to practice and their registration with the Public Company Accounting Oversight Board.

Initially, U.S. audit firms entered the Chinese market as joint ventures with Chinese partners. The Big Four in most countries are owned by local partners, operating more like a franchise than a typical multinational corporation. China has required the Big Four to convert into limited liability partnerships as their 20-year joint venture terms began to expire in late 2012. In May 2012, the Chinese government announced that by December 31, 2017, the Big Four must evolve into partnerships in which Chinese-qualified accountants are a majority of the firm’s accountants. The new regulation will cap the level of foreign-qualified accountants at the firms at 40 percent initially and at 20 percent by the end of 2017. In addition, the regulation will limit the voting rights of all partners with foreign qualifications and require that all senior partners be Chinese citizens. This change will limit U.S. corporate opportunities to manage audit operations, further complicating SEC enforcement efforts in China.^{175,176}

Accounting Fraud Impacts U.S. Companies Operating in China

Fraud and accounting problems associated with China are not limited to U.S.-listed Chinese companies. U.S. companies have directly invested \$54 billion in Chinese businesses, factories, and property, most of it in the past decade, according to the Department of Commerce. U.S. corporations' China operations are facing increasing problems. For example, on January 18, Caterpillar disclosed "deliberate, multi-year, coordinated accounting misconduct" at a unit of ERA Mining Machinery Ltd., a company it paid \$654 million to acquire in June 2012. Caterpillar has disclosed inventory discrepancies, inflated profits, and improperly recorded costs and revenue at the ERA Siwei unit, located in Zhengzhou, China. The Caterpillar experience and the growing catalog of smaller instances of deception and abuse involving U.S. companies' China corporations indicate that U.S. companies' Chinese investments experience unique accounting and governance challenges. The financial and legal advisors for Caterpillar and ERA included Citigroup, Freshfields Bruckhaus Derringer LLP, Blackstone, and DLA Piper. It appears that they did not detect the fraud prior to the deal closing.¹⁷⁷

Risk Management and Bilateral Cooperation

All accounting firms that audit U.S.-traded public companies and their employees must register with the Public Company Accounting Oversight Board. The Public Company Accounting Oversight Board sets auditing standards and rules for U.S.-listed companies and is charged with inspecting and regularly reviewing the audits of all public accounting firms that audit U.S.-listed companies, including those firms that audit foreign-domiciled, U.S.-listed companies and are themselves domiciled outside of the United States.¹⁷⁸ According to Ms. Fornelli, as of June 2011 there were 54 Chinese mainland auditing firms and 55 Hong Kong firms registered with the Public Company Accounting Oversight Board, and the board had performed more than 200 inspections of non-U.S.-domiciled accounting firms in over 35 jurisdictions, including Brazil, India, Japan, and Russia.^{179,180}

Recognizing a need to improve U.S. financial regulators' ability to gauge the financial health of companies domiciled in other jurisdictions, Congress empowered the Public Company Accounting Oversight Board to negotiate agreements for reciprocal inspections with audit regulators outside the United States as well as the confidential exchange of information with other regulators. This was part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Such cooperation between the board and foreign auditing oversight bodies was intended to encourage jurisdictions to better harmonize auditing standards and requirements. The goal was to eliminate such conflicts as the SEC's requests for documents that U.S. accounting firms cannot produce under Chinese law but must produce under U.S. law.¹⁸¹ Ms. Fornelli testified that the Public Company Accounting Oversight Board now has cooperation agreements with 16 nations and that after the 2010 Strategic and

Economic Dialogue, the United States and China announced their intent to negotiate such an agreement on the sharing of confidential information for regulatory purposes.¹⁸² However, the Public Company Accounting Oversight Board and the China Securities Regulatory Commission have yet to achieve that goal.

The inability of the Public Company Accounting Oversight Board to inspect in China creates a gap in investor protection. This lack of an information-sharing agreement with China does not just limit U.S. regulators' ability to ensure proper conduct at the Big Four accounting firms. It also limits their ability to ensure proper conduct at the Chinese-domiciled accounting firms that audit or play a substantial role in auditing U.S.-listed Chinese companies and the Chinese operations of U.S. companies. Though U.S. securities law requires overseas auditing firms that audit U.S.-listed companies to undergo inspection by the Public Company Accounting Oversight Board to ensure that they are following U.S. standards, China wants the United States to allow the China Securities Regulatory Commission and the Chinese Ministry of Finance to conduct and control all investigations of accounting firms in China, via an audit oversight agreement similar to the one it struck with the European Union. According to a statement by Mr. Gillis:

*In a 2009 letter commenting on the PCAOB's [Public Company Accounting Oversight Board] proposed delay in the deadline for foreign inspections, the CSRC [China Securities Regulatory Commission] said that any oversight of Chinese accounting firms should rely solely on the CSRC. In 2011, the European Union recognized the equivalence of the audit oversight systems in 10 third countries, including China. The third countries and EU [European Union] member states can now mutually rely on each other's inspections of audits. Chinese regulators want the same treatment from the United States, but U.S. laws do not permit the PCAOB to rely on foreign regulators.*¹⁸³

Chinese regulators have been reluctant to offer joint inspections, as they view such access as a breach of national sovereignty. If they do agree to some form of joint inspections between Chinese and U.S. regulators, they will likely insist on retaining full control over punishment of violations by Chinese auditors. The Public Company Accounting Oversight Board has been in negotiations with Chinese regulators since 2010 to try to work out an agreement and previously set a December 31, 2012, deadline to complete inspections of Chinese accounting firms. With this deadline passed, failure to reach a breakthrough in negotiations in the near future "could lead to the deregistration of Chinese accounting firms and a mass delisting of Chinese stocks," since U.S.-listed Chinese companies would no longer have a registered auditor and thus would have to delist.¹⁸⁴

On May 24, 2013, the United States and China announced a deal for limited information-sharing between their regulatory agencies when there are questions regarding audits of U.S.-listed Chinese companies. Under the agreement, the U.S. Public Company Accounting Oversight Board will be permitted access to audit documents from Chinese accounting firms to use in board investiga-

tions. This deal to facilitate information-sharing during investigations related to possible sanctions is a step in the right direction, but it does not resolve the board's challenges with regard to regular inspections of Chinese auditing firms, and it is inspections, rather than investigations, that are the Public Company Accounting Oversight Board's main function. Under U.S. law, "firms that issue reports on public companies are to be inspected at least every three years" to ensure that they are in compliance with U.S. auditing standards, but Chinese law still prohibits auditors from providing documents to the Public Company Accounting Oversight Board for such inspections.¹⁸⁵ At the July meeting of the Strategic and Economic Dialogue, U.S. Treasury Secretary Jack Lew announced that Chinese regulators had agreed to turn over to the SEC certain requested audit work papers of some Chinese companies listed on U.S. stock exchanges, a move that will assist the SEC in ongoing investigations.* However, no further progress has been made toward achieving more general direct access to documents for U.S. regulators conducting investigations or inspections. The May deal also permits China to withhold documents from the Public Company Accounting Oversight Board "on grounds of public interest or essential national interest."¹⁸⁶ As Mr. Gillis explained in a May 2013 Op-Ed for the *Wall Street Journal*, failure to resolve these issues more fully could lead the SEC and the Public Company Accounting Oversight Board to ban Chinese accounting firms from auditing U.S.-listed companies, which could in turn lead to Chinese companies being delisted from U.S. exchanges. However, this is a "nuclear option" that U.S. regulators are likely reluctant to pursue.^{187,188}

Implications for the United States

The rate of China's economic growth over the last 30 years, and its integration of a fifth of the world's population into the global economy, has profound implications for economic growth and job creation in the United States. China is currently America's third-largest export market and its fastest-growing export destination. U.S. exports to China have increased sixfold since 2001, with 48 states experiencing at least triple-digit growth in their exports to China and 20 states experiencing quadruple-digit growth. That is seven times the pace at which U.S. exports to the rest of the world have increased over the same time period.¹⁸⁹ However, the growth of U.S. imports from China still far surpasses this growth in exports to China. (For further discussion of the deficit, see chap. 1, sec. 1, of this Report.) A more consumption-driven Chinese economy would mean an expansive growth in Chinese demand for American products and services. But China lacks the modern and sophisticated financial sector needed to accomplish the shift to greater domestic consumption.¹⁹⁰ Without a more open and mar-

* Achieving direct access to documents that the Big Four auditing firms have refused to turn over will aid the SEC in moving forward with its investigations into certain Chinese companies listed on U.S. exchanges, including specifically the Deloitte-audited company, Longtop Financial. As of the drafting of this Report, the SEC's administrative trial against Chinese affiliates of Deloitte and the other Big Four audit firms in response to their refusals to turn over audit documents is ongoing. The presiding judge has reportedly requested a 100-day extension in the case, pushing the due date for a decision to January 7, 2014.

ket-oriented financial system, China cannot deliver on its promised economic rebalancing, and the costs of the imbalances in the U.S.-China economic relationship will continue to accrue.

While available measures indicate that China's shadow banking sector remains smaller than that of the United States, its size relative to China's formal banking sector continues to expand, and Beijing's efforts to curb the risky lending in this sector to date may perversely be fueling it. Expressing concerns about wealth management products in January 2013, Xiao Gang, former chairman of the Bank of China and current head of the Chinese Securities Regulatory Commission, reportedly characterized the shadow banking sector as "a potential source of systemic financial risk," whose model is "fundamentally a Ponzi scheme."¹⁹¹ In September, the G20 echoed this view when it endorsed new global rules for shadow banking issued by the Financial Stability Board.¹⁹² While the potential risks of China's shadow banking sector are not fully understood, to the extent that it poses systemic risks to China, it is fair to surmise that it poses risks for international financial stability more broadly. It is in the interest of the United States for Beijing to succeed in its efforts to curb risky, off-balance-sheet lending and establish greater regulatory control over nonbank financial institutions.

China's opaque policies and practices with regard to corporate accountability present serious challenges for U.S. companies and U.S. investors seeking information on the risks entailed in their transactions.

Conclusions

- The Chinese economy weathered the first few years of the global economic downturn by doubling down on its time-tested strategy of funneling capital into domestic development projects. But five years on, global demand for Chinese exports remains too weak to sustain the country's factories, much less new ones, and the merits of massive infrastructure projects have more than run their course. The policy decisions that kept the Chinese economy chugging over the last few years have also sped it closer to a reckoning that economists have long forecast would eventually be necessary.¹⁹³ If a rebalancing of the U.S.-China economic relationship is to be achieved, China must reform its financial system to support newer, nonstate sources of economic growth, which will require that China's banks better service its private sector.
- As long as China's official, regulated channels of credit do not possess the flexibility to meet the needs of the Chinese economy's main job creators, China will be at risk of depressed economic growth, which in turn may limit the growth of U.S. exports to China and the prosperity of U.S. investments in China, slowing economic recovery here at home. The shadow banking system that Beijing has allowed to step into this credit gap is insufficiently regulated and, if left unchecked, will pose an increasingly serious threat to Chinese and global economic stability.

- The opacity of Chinese corporate governance and accountability policies, as well as conflicts with U.S. securities laws and regulations, hurts investor confidence in Chinese companies trading on U.S. exchanges. The current situation threatens U.S. investors with unforeseeable and unmanageable losses and may lead to a broad delisting of Chinese companies. China's lack of sophisticated banking, corporate governance, and auditing policies and practices also hinders much-needed growth and opportunity for the very U.S. financial services firms that could help China to restructure its system if they were allowed greater access to the Chinese market.
- Insufficient transparency and accountability in China's financial sector put U.S. firms at risk of violating laws in both China and the United States; pose unreasonable hazards for U.S. investors with shares in Chinese companies; and render some U.S. laws and regulations unenforceable. Without greater regulatory transparency and assurance of China's regulatory, oversight, and enforcement capabilities, Chinese firms also risk curtailment or even revocation of access to the U.S. market.

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SECTION 4: CHINA'S AGRICULTURE POLICY, FOOD REGULATION, AND THE U.S.-CHINA AGRICULTURE TRADE

Introduction

China's World Trade Organization (WTO) accession in 2001 was a watershed event for U.S. agriculture. China is now the primary export market for U.S. agriculture products.¹ While the United States ran a \$315 billion trade deficit in goods with China in 2012, it achieved a \$21 billion surplus in agriculture.² Since full implementation of the WTO accession in 2005, China's agriculture imports from the United States have risen by an average of \$2.5 billion each year, exceeding the U.S. Department of Agriculture's (USDA) initial estimate of \$2 billion.³

A prime beneficiary of this farm trade boom is Iowa, one of the nation's largest agricultural states.⁴ Twenty years ago, China and Taiwan accounted for 6 percent of Iowa's agricultural exports. By 2012, they accounted for over 20 percent. That has helped sales of Iowa's agricultural products triple to \$30 billion in just a decade.⁵ Iowa farm real estate is now worth three times the national average.⁶ Moreover, Iowa has enhanced the U.S.'s agriculture diplomacy with China. Iowa officials claim a "special relationship" with China's new president, Xi Jinping, who spent time in the state as a young official.⁷ U.S. Agriculture Secretary Tom Vilsack in February 2012 hosted Mr. Xi and Agriculture Minister Han Changfu at the first U.S.-China Agricultural Symposium in Des Moines. The two countries signed the first U.S.-China Plan of Strategic Cooperation in Agriculture (2012–2017).⁸ Weeks after the symposium, the USDA led the largest ever agricultural trade mission to the Mainland.⁹

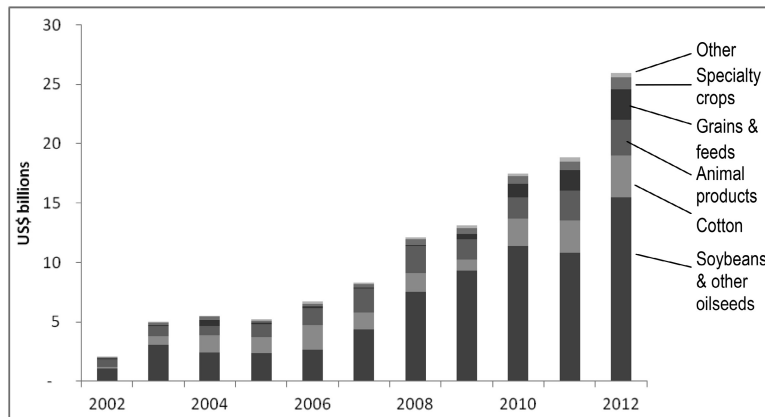
The Commission consequently chose Iowa State University in Ames as the location for an April hearing on China's agriculture policy and the U.S.-China trade in agriculture products. Among the witnesses was Iowa Secretary of Agriculture William Northey. The Commissioners also traveled to China in July to meet with Chinese officials, researchers, and producers as well as U.S. food companies. These activities complemented the Commission's 2008 hearing in New Orleans, which examined the economic and safety impacts of China's seafood exports to the United States.¹⁰

The hearing and trip illustrated the potential for deepening U.S.-China agriculture ties. China must feed a fifth of the world's population with less than a tenth of its arable land and potable water.¹¹ As China transforms into an urban society with a growing middle class, per capita food consumption is rising and, with it, the demand for higher-protein diets—a demand that U.S. farmers are well positioned to fill. China also seeks to make its farmers more

productive, and U.S. agencies, companies, and universities are helping China to do that. The United States, with its distinct advantages in resources, productivity, and quality, should benefit from a free market in farm goods.

However, the Commission takes note of serious problems in the bilateral relationship. These problems are detailed in this section. Many in the U.S. agriculture industry lobbied Congress in 2000 to grant China permanent normal trade relations, because they expected China to become a major purchaser of U.S. food products once it joined the WTO.* But yesterday's farm belt advocates have been disappointed that China has concentrated its purchases on bulk commodities, such as soybeans used as animal feed for China's outsized livestock industry (see figures 1 and 2). China's agriculture policy favors domestic production, even when it is unsustainable and nonessential to food security. In trade, China has used nontariff barriers to restrict imports of higher value-added products from the United States. Of particular concern are antidumping duties on U.S. broiler chickens; a ban on U.S. beef; and zero tolerance for even the small amounts of growth-inducing chemicals used in U.S. pork feed lots. For the bulk goods that China does import, such as soybeans, cotton, and corn, value-added processing largely takes place in China, costing the United States opportunities to create new jobs.

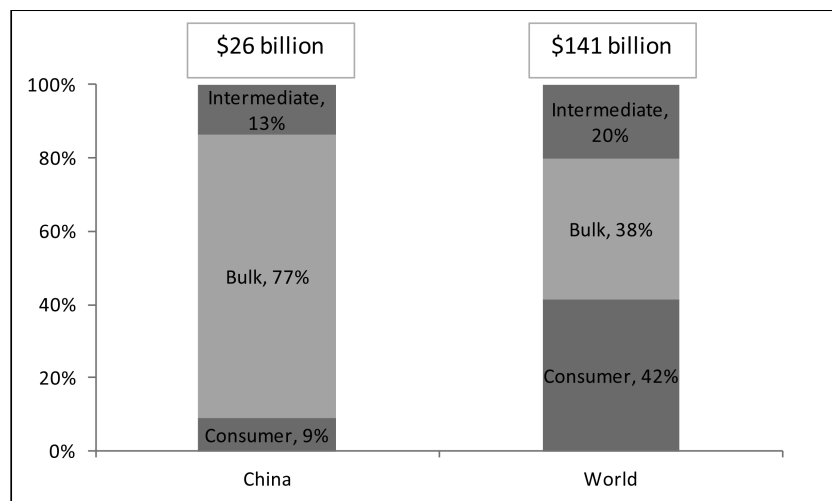
Figure 1: Value and Composition of U.S. Agricultural Exports to China, 2002–2012
US\$ billions



Source: USDA (Washington, DC: Foreign Agricultural Service, 2013).

* Granting China permanent normal trade relations, also known as Most Favored Nation status, was a precursor to China's admission to the WTO the following year. President Bill Clinton also pushed for permanent normal trade relations as a way to widen access for U.S. agricultural exports to China. The White House, "Clinton Says U.S. Has Key Role in China" (Washington, DC: Office of the Press Secretary, February 24, 2000). For a comprehensive forecast of market access by product, see Jonathan R. Coleman, Jonathan T. Fry, and Devry S. Boughner, "The Impact of China's Accession to the WTO on U.S. Agricultural Exports" (Washington, DC: U.S. International Trade Commission, September 2002).

Figure 2: Basic Composition of U.S. Agricultural Exports to China and to the World, 2012
Share (%)



Notes: Due to a rounding error, totals may not add up to 100.

Under the USDA's classification system, "bulk commodities" refer to crops shipped in raw form, such as wheat, coarse grains, rice, soybeans, and cotton; "intermediate goods" refer to processed crops, such as flour, soybean meal, and feeds and fodders as well as products not directly for consumer use, such as live animals, planting seeds, hides and skins, and sweeteners; "consumer-oriented products" include, among others, meat and dairy products, fruits and vegetables, and snack foods.

Source: USDA (Washington, DC: Foreign Agricultural Service, 2013).

The emerging trade relationship with China also poses risks to the food industry on U.S. shores. China has not done enough to promote food safety for its own people but maintains a trade surplus with the United States in consumer foods. U.S. consumers eat large amounts of fish, fruits, and vegetables, as well as vitamins and food supplements, produced in China.* U.S. government food safety inspectors have been unable to sufficiently monitor the safety of these imports and have been restricted, too, in their access to food production sites within China. At the same time, Chinese food companies, led by pork producer Shuanghui Group, are beginning to acquire productive assets in the U.S. food sector. Such investments could improve China's food production by helping its companies to adopt best practices. For the United States, they also have implications for net economic benefits, intellectual property, and reciprocal market access.

China's Changing Consumption Needs

China's economic development over the past 30 years has caused a structural shift in the country's dietary habits. In 1980, China consumed 68 percent less meat per capita than the world average;

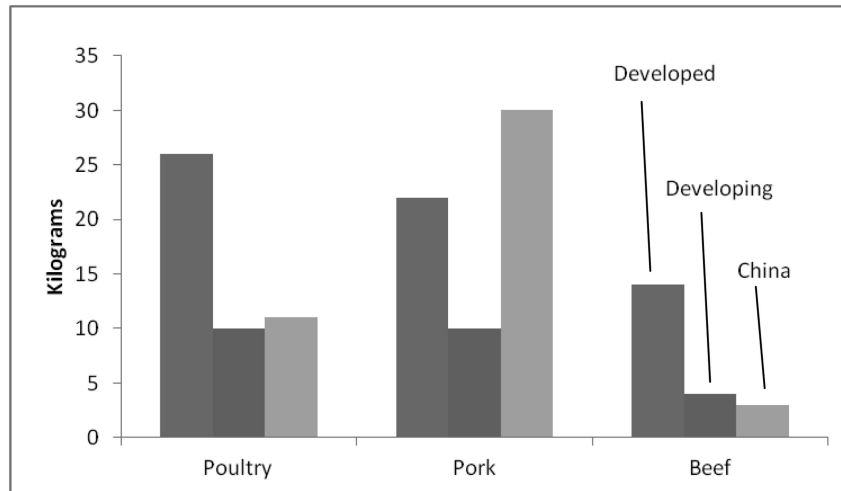
*For more information, see U.S.-China Economic and Security Review Commission, *Hearing on China's Enforcement of Intellectual Property Rights and the Dangers of the Movement of Counterfeited and Pirated Goods into the United States* (Washington, DC: June 7-8, 2006).

today, it consumes 19 percent more.¹² There is still room for additional meat consumption. Although economic growth is slowing, China's population of 1.3 billion is seeing a faster rise in real wages than previously, and just over half of the population now lives in cities. Urbanization and higher incomes tend to correlate with protein-based diets.* Owing to income inequality among regions, rural and urban areas, and individual households, meat is enjoyed mostly by a small segment of China's population.

Chinese consumers could also diversify their dietary intake. China currently consumes around half of the world's pork, equivalent to 30 kilograms of pork per capita each year, far higher than the rest of the world. In contrast, its consumption of beef and poultry is relatively low. Poultry consumption per capita is about ten kilograms per year, compared to 42.4 kilograms in the United States (see figure 3). Poultry is a lower-cost option for increasing protein intake. Speaking on behalf of the U.S. Poultry and Egg Export Council, which represents 95 percent of the U.S. poultry industry, DTB Associates' Kevin Brosch forecast the impact that China would have on world markets if it increased its annual per capita consumption of poultry: at Japan's modest level of 17 kilograms per annum, China would require an amount equal to all current world exports of poultry.¹³

Figure 3: Per Capita Meat Consumption: China vs. Other Countries, 2012

Kilograms per capita per year



Source: Organization for Economic Cooperation and Development (OECD)/Food and Agriculture Organization (FAO), *Agriculture Outlook*, June 2013, via U.S. Meat Export Federation (Denver, CO).

*A more technical explanation of this phenomenon is the income elasticity of demand, or how much demand for a given product rises or falls with increases in income. Income elasticities in China, as in many other countries, have been negative for rice, wheat, and coarse grain, such that China consumes less of these products as it becomes wealthier. By contrast, its consumption of pork, poultry, and especially beef and fish will continue to rise rapidly with added income. Scott Rozelle, "Overview of China's Agricultural Development and Policies" (Center for Chinese Agricultural Studies, January 2010).

China's distinct dietary preferences provide additional opportunities to U.S. producers. The United States has a surplus of exactly those parts of the animal, such as pork offal and chicken paws, that Chinese consumers prize. These products can be sold at a much higher price in China than the United States.¹⁴ The U.S. meat products exported to China are predominantly in these categories.¹⁵ As Dermot Hayes of Iowa State University told the Commission, if U.S. producers could sell the other half of the carcass in China at a premium, they could double their revenue without significant production cost increases.¹⁶

As Chinese consumers change their diets, they are seeking safer food as well. Some of this vigilance has resulted in suspicion of new technologies, such as genetically modified foods.* A spate of food safety scandals in China has also made consumers justifiably worried about what they are eating. China's food production industry is highly fragmented. Many producers at the farming, processing, and distribution levels forgo safe practices in order to cut costs.¹⁷ Food is adulterated, among other things, by the excessive use of fertilizers and pesticides; growth-enhancing antibiotics for livestock; and toxic chemicals that artificially enhance the freshness, appearance, or nutritional value of food. Due to false or incomplete labeling, harmful ingredients are often not disclosed.¹⁸

In response, Chinese citizens, with the aid of new social media, are seeking more information about food safety beyond government sources. Many have voiced grievances about a "special food supply" that caters to government officials.† Chinese consumers are also transitioning from wet markets to supermarkets,‡ in the process becoming more attentive to third-party labeling, traceability, and trusted brands.¹⁹ Those with more disposable income are turning to premium food products to ensure safety. Interest in organic food is spreading, ranging from farmers' markets to community farming and organic food clubs.²⁰ On the outskirts of Xi'an in western China, the Commission visited a company that combines a vegetable seed business with organic food production. Members of the

*The Chinese public remains very divided about genetically modified (GM) foods. Some critics, inspired by Japan and the European Union, maintain that GM foods are not safe for either production or consumption. Oddly, China has yet to legalize the planting of GM crops, even though it has invested large amounts in developing its own biotechnology. China does, however, import GM crops, such as soybeans and corn, which are fed to China's livestock. Some argue that this intermediate form of GM food consumption is less obvious to consumers and hence less controversial. Jikun Huang et al., "A Consumer Segmentation Study with Regards to Genetically Modified Food in Urban China," *Food Policy* 35 (2010): 456-62.

†"Special food supply" refers to food for Chinese officials grown at special production sites. The system was first established under Soviet influence in the 1930s as a means to protect the Communist Party leadership against famine. Today, special food supply sites in China are associated with organic food production. While the precise quantity and nature of these production sites is unclear, articles in the Chinese media indicate that the "special food supply" has caused some consternation among ordinary Chinese. Barbara Demick, "In China, What You Eat Tells Who You Are," *Los Angeles Times*, September 25, 2011, via Factiva database; Jiang Gaoming, "Jiang Gaoming: Shipin tegong jidi pinxian tuxian shipin jianguan ganga" (Jiang Gaoming: The Appearance of New Special Food Supply Sites Is an Embarrassment to China's Food Regulators), *Guangming Wang* (Guangming Net), February 25, 2013. http://health.gmw.cn/2013-02/25/content_6800842.htm; Nandu online, "Hu Xingdou: Jianyi quxiao tegong zhidu, jie jue tequan fubai" (Hu Star: Recommendations on Eliminating the Special Food Supply System, and Resolving the Corruption of Special Privilege), May 14, 2013. <http://ndnews.oeeee.com/html/201305/14/59741.html>; and Fazhi Ribao (China Law Daily), "Tegong shangpin wushi zhengce, xuezhe cheng bufen guojia jiguan tan xiaoli," (Special Supply Products Unregulated, Scholars Ascribe It to Greed in Some Government Agencies), February 2, 2012. <http://politics.people.com.cn/BIG5/16998050.html>.

‡A wet market is a fresh food market commonly found in Asian countries. It often sells live animals and raw meat.

company's organic food service pay an annual fee of around \$800 to have organic food shipped to their homes.²¹

Worries about food safety are also boosting food imports. A striking example is the dairy sector. The adulteration of infant formula with melamine, a toxic industrial solvent, caused China's dairy imports to grow at an annualized rate of 45 percent between 2009 and 2012—more than double the previous rate and double the rate of increase in total food imports.²² Mainland Chinese are buying baby formula and ultra-high-temperature milk from the shelves of supermarkets in other countries, where retailers have been compelled to ration sales to limit hoarding.²³

Reacting to the rise in consumer demand, the Chinese government has begun to allow some imports of U.S. premium consumer foods bearing the “USDA approved” logo. U.S. pear farmers, for example, received import licenses from Beijing in early 2013 and plan to focus on wealthy consumers concerned about the safety of domestic pears.²⁴ These U.S. products often directly compete with goods produced in China.

Examples of Food Safety Scandals in China

In recent years, food safety scandals in China have affected a variety of consumer food items:

Dairy Products

Melamine mimics the nutritional values of protein. It has been used in China to mask the low protein content of dairy products, such as milk powder and infant formula. In 2008, six infants were killed, and more than 12,000 were hospitalized with kidney and other organ damage from adulterated formula. The scandal led to the execution of two producers and prison terms for dairy company executives. In February 2011, reports emerged of another milk contamination scandal involving leather-hydrolyzed protein. The toxic additive has also been found in such processed products as candy, hot cocoa, and flavored drinks, some of which are exported from China to other countries.

Fruits, Vegetables, and Tea

Police in the northeastern city of Shenyang seized 40 tons of bean sprouts in 2011 that had been treated with sodium nitrite, urea, antibiotics, and plant hormones. Wholesale vegetable dealers in Shandong Province in 2012 were found spraying cabbages with formaldehyde to preserve them during transport without refrigeration. Chinese media in 2012 reported that fruit from 16 companies contained excessive pigments, bleaching agents, and preservatives. Testing by Greenpeace found at least three different kinds of pesticides in each of 18 varieties of tea.

Examples of Food Safety Scandals in China—Continued

Meat and Fish

Pork is sometimes adulterated with clenbuterol, a lean meat additive that can cause dizziness, heart palpitations, and diarrhea. Other reports have identified pork contaminated by phosphorescent bacteria, while rat meat has been substituted for lamb sold on skewers in Beijing. A 2012 report revealed that fish vendors in Beijing were using a chemical ordinarily meant for temporary dental fillings in order to tranquilize fish during transport.²⁵

China's Unsustainable Agriculture Policy

The Focus on Self-Sufficiency and Domestic Production

China has seen the fastest growth in agricultural output of any major economy over the past 30 years. In the Maoist period (1949–76), agronomists feared that China would place a strain on the world food system by being unable to feed itself. Today, China produces over 20 percent of the world's cereal grains, 25 percent of the world's meat, and 50 percent of the world's vegetables.²⁶ Based on a common definition of arable land, the United States has more than twice the cropland of China, yet China's output is two-and-a-half times that of the United States.* China feeds not only its own population of 1.3 billion—it is also the world's largest exporter of numerous foods, including apple juice, farm-raised fish, garlic, and vitamin C.²⁷

Beijing's agriculture policy has played a role in enhancing China's food productivity. Until the late 1970s, the government mostly procured agricultural goods from farmers at below-market rates. Reforms in the 1980s allowed farmers to sell some production on the open market at a higher return and established a land contracting system that permitted the leasing of land for several decades. Beginning in the 1990s, China's opening to world markets led to more export-oriented production, inbound foreign direct investment, and international development support from aid agencies such as the United Nations and the World Bank.²⁸

The government is seeking ways to further modernize the agriculture sector. Crop yields, for instance, are still below potential due to poor planting techniques and postharvest waste.† The government has responded with ambitious measures. Since joining the WTO, China has increased its research and development (R&D) spending on agriculture more rapidly than any other country.²⁹

* China has achieved greater agricultural output than the United States with a smaller share of arable land. As outlined in this section, this phenomenon is mainly attributable to the intensive and unsustainable use of labor, resources, and land. Dense livestock production, double-cropping, overuse of fertilizers and pesticides, and land reclamation in arid regions are some examples of intensive farming methods. Relative to the United States, the productivity of China's farming sector remains very low. U.S.-China Economic and Security Review Commission, *Hearing on China's Agriculture Policy and U.S. Access to China's Market*, testimony of Dermot Hayes, April 25, 2013.

† Postharvest waste refers to the loss in the process of storing grain after it is harvested. In China, grain crops are often exposed to adverse natural elements due to the lack of adequate storage facilities. Shannon Herzfeld (vice president, Archer Daniels Midland), telephone interview with Commission staff, Washington, DC, August 9, 2013.

China's 12th Five-Year Plan (2011–2015) for the first time shifts the explicit focus of agriculture policy from rural development to boosting agricultural output. It lays out a blueprint for consolidating industry, modernizing production facilities, and promoting regional specialization.³⁰ The 12th Five-Year Plan has been complemented by the No. 1 Document—China's first policy document each year, which since 2004 has been devoted to agriculture. The most recent No. 1 Document, issued in January 2013, summarizes a comprehensive set of policies, including incentives for new farming operations; corporate investment in agriculture; food grain security measures; and credit for farmers.³¹ During the Commission's July 2013 trip to China, participants met with top scientists at the Chinese Academy of Agriculture Sciences who are exploring ways to boost productivity through farmer training, satellite mapping, biotechnology, and reclamation of arid and polluted soils.³²

However, many of China's agricultural policies are inefficient and unsustainable. These policies are driven, in part, by the government's emphasis on attaining self-sufficiency across a broad spectrum of food products, when a more rational policy would be to import products for which China lacks a comparative advantage. Beijing keeps official targets of 95 percent self-sufficiency for corn, wheat, and rice. In practice, it also maintains near self-sufficiency for pork, poultry, and beef (see table 1). According to a typically optimistic forecast by Huang Jikun, a top researcher at the government's Chinese Academy of Science's Center for Chinese Agricultural Policy, China by 2025 will have *no* trade deficit in either meat products or wheat and rice and will continue to be a net exporter of fruits, vegetables, and farm-raised fish.³³

Table 1: China's Self-Sufficiency in Beef, Pork, and Broiler Chickens, 2009–2012

1,000 metric tons per year

	2009	2010	2011	2012
<i>Beef</i>				
Production	5,764	5,600	5,550	5,540
Consumption	5,749	5,589	5,524	5,597
Surplus/deficit	15	11	26	(57)
Surplus/deficit share of consumption	0.3%	0.2%	0.5%	–1.0%
<i>Pork</i>				
Production	48,905	51,070	49,500	52,350
Consumption	48,823	51,157	50,004	52,275
Surplus/deficit	82	(87)	(504)	75
Surplus/deficit share of consumption	0.2%	–0.2%	–1.0%	0.1%
<i>Broiler chickens</i>				
Production	12,100	12,550	13,200	13,700
Consumption	12,210	12,457	13,015	13,543
Surplus/deficit	(110)	93	185	157
Surplus/deficit share of consumption	–0.9%	0.7%	1.4%	1.2%

Source: USDA, "Livestock and Poultry: World Markets and Trade," (Washington, DC: Foreign Agricultural Service, April 2013). http://www.fas.usda.gov/psdonline/circulars/livestock_poultry.pdf.

Misallocation of Resources for Meat Production

A central problem of China's agriculture policy is its concentration on livestock production. China accounts for half of the world's pork output. It is also the world's largest producer of farm-raised fish, second-largest producer of poultry, and third-largest producer of beef.³⁴ Meat is an inefficient way to deliver calories, as it requires land- and water-intensive production of grain crops to feed animals instead of humans. For example, 1,799 gallons of water may be required over the life of a cow before it is slaughtered.³⁵ China's low productivity, coupled with its lack of resources, exacerbates these inefficiencies.

China lags far behind the United States in its ability to convert livestock into meat. China last year bred 15 percent more cattle than the United States—104 million head—but produced less than half as much beef. China produced five times more pork than the United States but required seven times as many hogs.³⁶ Nor is productivity necessarily improving over time. China's hog herd grew by 0.6 percent per annum in the 2000s, compared to 2.7 percent in the 1990s. China's pork output slowed even more over the two decades, from 5.9 percent to 2.2 percent per year.³⁷ Following an outbreak of blue ear pig disease* that killed off much of the herd, China's pork production actually contracted by 7.8 percent in 2007.³⁸ In contrast, the United States is achieving record pig herds and pork output, due to improved genetics and swine management techniques that have had more baby pigs survive to maturity.³⁹

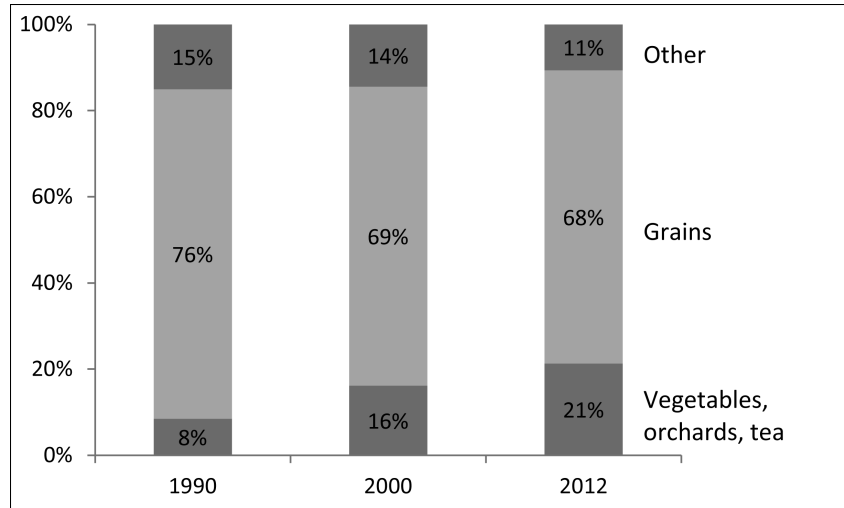
As a consequence of livestock production, China is using scarce resources to produce grain crops for animal feed. In the 1990s, China began to devote more acreage to horticulture cash crops. Yet over the past decade, that reallocation of land has slowed, such that grain crops still account for 68 percent of sown land (see figure 4). Within the grain sector, corn has overtaken rice as China's most widely planted and produced crop—reflecting the booming demand for corn feed.⁴⁰

China's focus on grain crops has also diverted valuable water resources to what is a less profitable crop. According to Dr. Hayes, it has been bad business for China's farmers:

Consider the human resource waste when a skilled farmer spends an entire year growing three acres of corn in a world where a single U.S. farmer can grow three thousand acres. If China were to allow the market to incentivize these farmers to grow high value crops such as flowers, fruits, vegetables and ornamental plants, total farm income and the value of farm output would soar.”⁴¹

* Blue ear pig disease, also known as porcine reproductive and respiratory syndrome, is a pandemic disease that causes reproductive failure in breeding stock and respiratory tract illness in young pigs. It was first reported in North America in the 1980s.

Figure 4: Distribution of Sown Area in China, 2002–2012
Share (%)

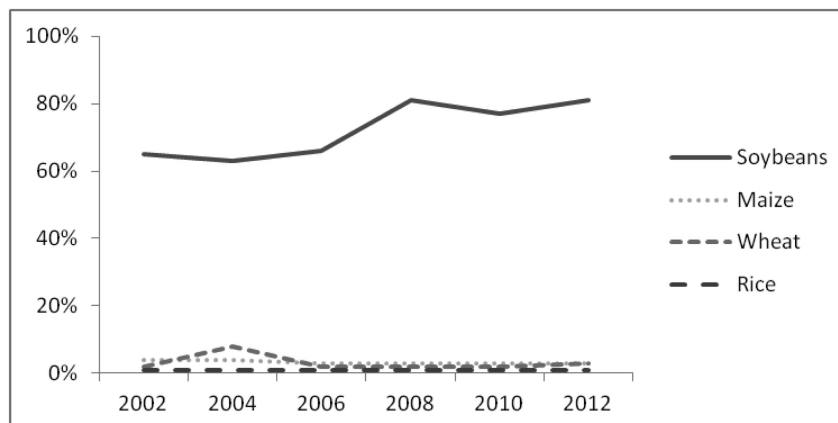


Note: Due to a rounding error, totals may not add up to 100.
Source: National Bureau of Statistics, via CEIC database.

In spite of China's commitment to planting grain crops, domestic crops have not sufficed to feed all of the country's livestock. The government in the late 1990s began to sanction imports of soybeans as an alternative source of animal feed. China now imports four-fifths of the soybeans it consumes (see figure 5).⁴² But even soybean imports are proving too little to meet China's need for feed grains. In 2010, China for the first time imported large quantities of corn. A recent Iowa delegation to China testified that corn imports will keep rising.* While these developments may bode well for U.S. corn farmers, the fact is that China is tacitly abandoning its 95 percent self-sufficiency policy for corn, even as it promotes its own large-scale corn production.

*When traveling to southern China in March 2013, a group from the Iowa Soybean Association heard an estimate from a private trader that China would be importing 20 million metric tons of corn in five years, up from small amounts of net corn imports today. U.S.-China Economic and Security Review Commission, *Hearing on China's Agriculture Policy and U.S. Access to China's Market*, testimony of William Northey, April 25, 2013.

Figure 5: Import Penetration of Major Crops in China, 2002–2012
Imports/Domestic Utilization (%)



Source: Food and Agriculture Organization, *Agricultural Market Information System* (Rome, Italy: Agricultural Information System: Secretariat). <http://www.amis-outlook.org/>.

The Impact of Food Production on China's Environment and Public Health

China's land and resources face rapid decline. It is doubtful whether the central government's target of maintaining 120 million hectares under cultivation can be met in the future. According to Dr. Hayes, China will continue to lose about 2.5 million acres, or up to 4 percent of its farm land, each year to urban development.⁴³ The remaining arable land is also becoming less useful. China's intensive fertilizer use per acre, the highest in the world, reduces soil fertility, causing a vicious cycle of ever more fertilizer application to achieve higher yields. Meanwhile, agriculture irrigation accounts for 65 percent of China's water withdrawal, compared to 40 percent in the United States.⁴⁴ Water tables in arid regions are being depleted.⁴⁵

Pollution of China's water, soil, and climate directly impact food quality. Only 6 percent of China's agricultural products were considered pollution free in 2005, according to figures compiled by the USDA. A study released in February 2011 found that 10 percent of all rice sold in China was contaminated with heavy metals.⁴⁶ Agriculture is a victim, but also a cause, of pollution. China's first national pollution census, released in February 2010, found that agriculture is a bigger source of water pollution than industry.⁴⁷ In order to produce vast quantities of pork, poultry, and farm-raise fish on limited land, China's breeders have resorted to high livestock density. For instance, China has kept five times the number of breeding sows—50 million—as the United States on much less farmland.⁴⁸ Consequently, livestock farms in China currently produce about four billion tons of manure annually. Manure could be used as nitrogen fertilizer for cornfields, but in China manure more often ends up as waste, because corn is planted in other re-

gions of the country.* That creates oxygen-depleting algae blooms and nutrient overloads in waterways, including the Yangtze and Yellow rivers. Not least, manure contributes to climate change by emitting methane gas into the atmosphere.⁴⁹

Dense livestock production has increased the incidence of animal diseases as well. In 2013, thousands of diseased pig cadavers were found floating in the river near Shanghai, dumped by illegal pork producers seeking to evade local food inspectors.⁵⁰ Similarly, in the poultry sector, the density of fowl has turned China into a breeding ground for avian influenza, with the most recent H7N9 outbreak occurring earlier in 2013.⁵¹ According to Fred Gale of the USDA, these animal disease outbreaks should “drive the [Chinese] leadership to acknowledge that the production of livestock has really grown beyond the carrying capacity of the country.”⁵²

In contrast, U.S. meat production is more environmentally sustainable than in China. In Iowa, where corn and pork are produced side by side, manure is used as nitrogen fertilizer, and corn is harvested at the source where it is needed, forming a localized, low-cost, and self-sustaining production cycle. Said David Miller of the Iowa Farm Bureau:

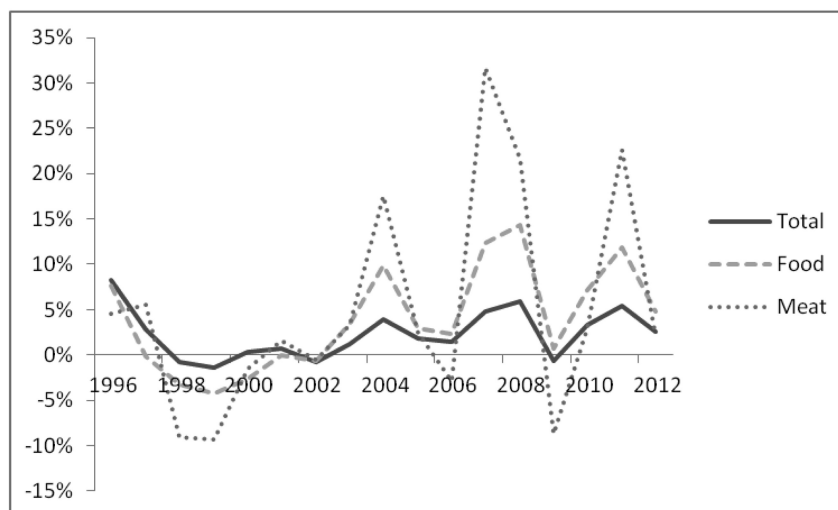
*From an environmental perspective, there is significant room for Iowa to increase pork production. Currently, Iowa farmers apply about one million tons of nitrogen from commercial fertilizer on Iowa farms and about 250,000 tons of nitrogen from manure. About 70 percent of the manure-based nitrogen is from hog production. If all of the commercial nitrogen for corn were to be replaced by nitrogen from hog manure, the Iowa hog herd would need to be currently five times as large as it is for increased production.*⁵³

The Cost of Domestic Production for Chinese Consumers

In addition to the food safety risks discussed above, China’s consumers worry about prices. Food has been the main driver of consumer inflation, which reached historic highs in the 2000s (see figure 6). Said Dr. Hayes, “They joke over there that the CPI [consumer price index] means consumer pig index, because if you spend 40 to 50 percent of your income on food, the thing you want to do is to upgrade to meat, and when that goes high, the Chinese government senses insecurity.”⁵⁴ Periods of unrest, such as the 1989 Tiananmen Square protests, have been accompanied by high inflation.⁵⁵ The Great Famine in 1958–1961, which killed an estimated 15 million to 40 million people on account of faulty government policy, is etched in China’s national psyche.⁵⁶

*China has been trying to diversify its hog production out of the Yangtze Delta into other parts of the country, particularly the North, where China’s grain crops are grown. However, these efforts have had limited success. Northern China’s hog production has remained around one-quarter of hog production since 1995. Kevin Chen and Wang Jimin, “Hog Farming in Transition: The Case of China” (paper presented at *Asian Livestock: Challenges, Opportunities and the Response*, Proceeding of an International Policy Forum, Bangkok, Thailand, August 16–17, 2012), p. 77; Mindi Schneider, “Feeding China’s Pigs: Implications for the Environment, China’s Smallholder Farms, and Food Security” (Minneapolis, MN: Institute for Agriculture and Trade Policy, May 2011), p. 3.

Figure 6: Annual Consumer Price Inflation in China, 1996–2012
Year-on-year (%)



Source: National Bureau of Statistics via CEIC database.

A policy of domestic meat production further raises costs. According to Dr. Hayes, feed costs alone make China's pork production and farm-level livestock 40 percent more expensive than in the United States. Soy meal prices are typically \$100 per ton and corn \$3 per bushel higher in China than in the United States, owing to shipping costs.⁵⁷ In view of China's widening income gaps, the burden of higher prices is especially harmful to low-income households that are forced to spend more on meat products.⁵⁸

Lack of Support for Rural Livelihoods

An underlying rationale for China to favor domestic production is to support the nation's farmers. According to the Central Intelligence Agency, one in three Chinese workers is still active in agriculture.* Agriculture net output accounts for 10 percent of China's GDP—compared to 1 percent in the United States.† China's market reforms have not done nearly as much to improve the well-being of the rural population as they have for the urban sector. Wages have risen much faster in cities, widening rural-urban disparities. Young people are leaving villages in droves to earn higher wages

*Due to China's large migrant population, off-farm employment in the rural sector, and subpar demographic data, there are varying estimates of the total population economically active in agriculture. See Central Intelligence Agency, *World Factbook* (McLean, VA). <https://www.cia.gov/library/publications/the-world-factbook/fields/2048.html>; Scott Rozelle, "Overview of China's Agricultural Development and Policies" (Center for Chinese Agricultural Studies, January 2010); and Peter Hooper et al, "Demographics and GDP Growth in China" (Frankfurt, Germany: Deutsche Bank, November 16, 2012).

†Net output refers to "agriculture, value added," which the World Bank defines as "the net output of a sector after adding up all outputs and subtracting intermediate inputs. It is calculated without making deductions for depreciation of fabricated assets or depletion and degradation of natural resources." World Bank Indicators (Washington, DC: World Bank). <http://data.worldbank.org/indicator/NV.AGR.TOTL.ZS>.

in factories.⁵⁹ China's National Bureau of Statistics estimates that China has 170 million migrant workers.⁶⁰

Maintaining rural livelihoods became a top priority for the Chinese leadership under the administration of President Hu Jintao and Premier Wen Jiabao (2003–2012). A document released at a central work meeting on rural development in December 2005 stated: "Only when the problems relating to agriculture, rural areas, and the farmers have been solved properly, can China's economy develop in the correct direction."⁶¹ The government enshrined these initiatives in the 11th Five-Year Plan for Agriculture (2006–2010), under the theme of "building a new socialist countryside."⁶² In 2006, all farmers were exempt from an agricultural tax that had been in place for millennia.⁶³ These policies built on the agricultural reforms initiated by Deng Xiaoping under the so-called "three rural issues," shorthand for the need to raise agricultural productivity, boost rural incomes, and provide welfare to rural migrants.⁶⁴

The leadership under Xi Jinping is now changing tack by encouraging an ambitious urbanization strategy. The goal is to fully integrate 70 percent of the country's population, or roughly 900 million people, into city living by 2025.⁶⁵ With a smaller rural population, agriculture could be concentrated around a core of wealthier farmers. Fewer farm laborers would, in theory, also make farmland more productive. Mechanization of cropland, for instance, could raise planting density, while larger pork feed lots would enhance efficiency and safety.⁶⁶

Nonetheless, a policy of urbanization and agricultural modernization will be difficult to realize. For one, China's successes in food production have relied heavily on labor intensity. Chinese farmers have planted multiple crops on the same land each year. A large portion of the country's livestock has been fed on manually collected food scraps and waste from restaurants. Low-wage farm workers have reclaimed land in rocky areas and hillsides that would not be considered arable in the United States.⁶⁷ In areas where bees have become extinct, farmers have pollinated trees by hand.* As farm labor declines, China will have to find means to mechanize and scale up production.

To this end, the government is experimenting with models to consolidate land. Yet, the institutional structures currently in place are not conducive to a U.S.-style system of production. China's average farm size is just 1.5 acres, down from 1.7 acres 20 years ago.⁶⁸ U.S. farms average 600 acres. The few large farms that are being established make only a small dent in overall production; in the pork sector, for instance, backyard farmers and small, specialized farms account for four-fifths of output.⁶⁹ Further, China's complex system of land distribution, whereby rural collectives led by local officials reserve the right to allocate land to farmers, rural enterprises, and urban developers, is politically contentious and has frequently led to expropriation.† The government took a step for-

* In line with a global trend, bees in China are becoming extinct. China's farmers therefore pollinate many horticultural crops by hand using artificial pollen substitutes. Stephen Holden, "In Fields and Hives, Zooming In On What Ails Bees," *New York Times*, June 11, 2013. <http://movies.nytimes.com/2013/06/12/movies/more-than-honey-a-documentary-by-markus-imhoof.html>.

† The policy that land should be contracted for 30 years with no adjustments became law when the Land Management Law was revised in 1998. Samuel P.S. Ho and George C.S. Lin,

ward in 2003 by banning large reallocations of land and permitting farmers to lease land to locals and nonlocals. That gave rise to a rental market that allowed less productive farm workers to relocate to cities. But to this day, land is owned at the village level and cannot be mortgaged.⁷⁰ Farmers' cooperatives in the United States help farmers to coordinate and scale up their production, but in China, only one in four villages hosts a cooperative. In an authoritarian system that restricts freedom of organization, local officials can curb the independence of cooperatives as well.*

The absence of a functioning welfare state in China poses a further obstacle to modernizing agriculture. The government has yet to reform the system of residence permits (*hukou*) in urban areas that would grant all rural migrants access to urban welfare provision (For more on urbanization, see chap. 1, sec. 1, of this Report.). Independent surveys show that younger family members are migrating to cities temporarily, while the elders stay behind to tend the land.⁷¹ Farmland, leased for 30 years, remains an important form of personal insurance that many migrants are reluctant to give up.

The Impact of China's Agriculture Policy on U.S. Exports

Measuring the Impact of China's WTO Violations

Prior to its WTO accession, China's trade barriers included exorbitant tariffs, quotas, state trading monopolies, and outright bans on some agricultural products. China agreed to eliminate most of these barriers. In 2002–2006, China lowered tariffs on agricultural goods of greatest importance to U.S. farmers and ranchers from a 1997 average of 31 percent to 14 percent. The last tariff reductions occurred in 2008. As Stanford agricultural economist Scott Rozelle has shown, the reduction in tariff rates allowed prices for many commodities in China to converge with world markets. China's average tariffs and supports for agriculture are now below those of several other WTO members, including the European Union, Japan, and South Korea.⁷²

The effects of China's trade liberalization are evident in its trade balance. China's net imports of food have surged from near zero to more than \$40 billion since 2004. As Colin Carter, professor of Agricultural & Resource Economics at University of California–Davis, told the Commission, China maintains an export-oriented horticulture industry, but imports of these products are outpacing exports.⁷³ Although China remains largely self-sufficient, a small adjustment in its imports has a disproportionate effect on global markets. Based on unofficial estimates that include Hong Kong, China is already the world's top importer of beef and pork.⁷⁴

Nonetheless, China keeps numerous nontariff barriers in place to restrict U.S. imports. They include excessive subsidies; government control over import quotas; discriminatory taxes; and sanitary and phytosanitary restrictions that are not based on proper scientific

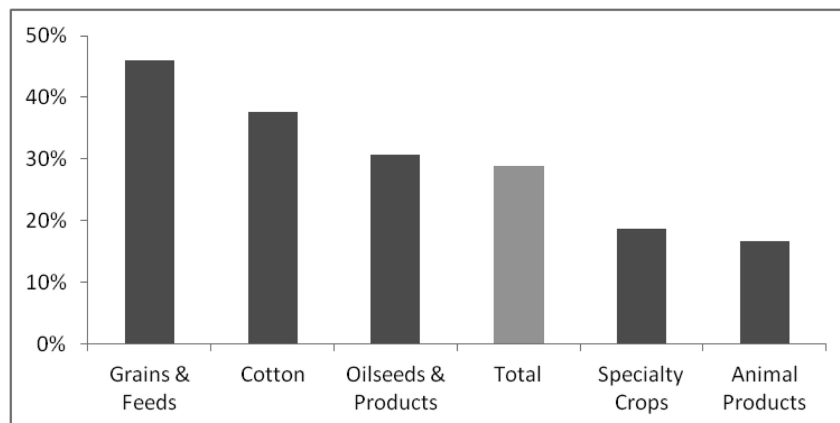
"Emerging Land Markets in Rural and Urban China: Policies and Practices," *China Quarterly* 175 (September 2003): 689–707.

*The technical term for China's cooperatives is "farmers' professional economic cooperative." Data from a 2009 survey by the Center for Chinese Agricultural Policy. Scott Rozelle, "Overview of China's Agricultural Development and Policies" (Beijing, China: Center for Chinese Agricultural Policy, January 2010).

analysis.* These measures have contributed to a very imbalanced food trade between the United States and China. U.S. soy farmers have reaped a windfall, accounting for three-fifths of U.S. agriculture exports to the Mainland in 2012.⁷⁵ China buys up to seven times more soybeans from the United States than Japan, the next-largest customer.⁷⁶ Yet other crops have not enjoyed fair and stable access. With the exception of dried distillers grains, a corn-based byproduct of U.S. ethanol production,[†] value-added products based on crops have also had limited success.

Worse still, U.S. consumer foods have entered China at a slower rate than total trade (see figure 7). China has banned U.S. beef for a decade. Although China is currently a top market for U.S. pork, China's pork purchases have been erratic due to unpredictable food safety-related bans. The U.S. Meat Export Federation claimed in 2012 that sanitary barriers posed "the single largest constraint to the expansion of U.S. beef, pork and lamb exports over the next five years."⁷⁷ After China placed antidumping duties on U.S. broiler chickens in 2010, poultry exports plummeted as well.

Figure 7: Annualized Growth of U.S. Agricultural Exports to China, 2002-2012
Compound Annual Growth Rate (%)



Source: USDA (Washington, DC: Foreign Agricultural Service).

China's nontariff barriers are often protectionist measures. According to Dr. Gale of the USDA, China's self-sufficiency policy is based on an exaggerated alarm about the risks of import reliance. Beijing presumably worries that the volume of potential Chinese

*Sanitary and phytosanitary regulations restrict or prohibit imports and marketing of certain animal species, or products, to prevent the introduction or spread of pests or diseases that these animals may be carrying. World Trade Organization, "Introduction to the SPS [Sanitary and Phytosanitary] Agreement" (Geneva, Switzerland: 2013). http://www.wto.org/english/tratop_e/sps_e/sps_agreement_cbt_e/c1s3p1_e.htm.

[†]Distillers' grains are a cereal byproduct of the distillation process. There are two main sources of these grains. The traditional sources were from brewers. More recently, ethanol plants are a growing source. Corn based distillers grains from the ethanol industry are commonly sold as a high protein livestock feed that increases efficiency and lowers the risk of subacute acidosis in beef. U.S.-China Economic and Security Review Commission, *Hearing on China's Agriculture Policy and U.S. Access to China's Market*, testimony of Julius Schaaf, April 25, 2013.

demand is so large that food imports would outstrip the capability of world markets to supply the country. There are also strategic concerns that reliance on imports of any particular commodity will leave China vulnerable to global price fluctuations and manipulation of prices by other countries or multinational companies.⁷⁸ In addition, China's agriculture policy manifests the government's broader industrial policy. In numerous industries, from furniture to textiles and steel, China imports raw materials for value-added processing. That policy frequently entails heavy subsidies for land, labor, and capital; selective market barriers for imports and foreign investment; and, increasingly, support for strategic enterprises and outbound investment in productive assets overseas.

Sanitary and Phytosanitary Barriers to U.S. Meat Exports

The WTO sets out clear obligations for member states to only use sanitary and phytosanitary restrictions that do not "arbitrarily or unjustifiably discriminate between WTO members' agricultural and food products, and are not disguised restrictions on international trade."⁷⁹ China has applied numerous food safety-based restrictions on trade that contravene these principles.

China has persistently banned U.S. meat products following epidemic outbreaks. In the interest of public health, countries customarily impose bans on imports if there is a related epidemic outbreak in the exporting country. China's bans, however, have frequently exceeded any necessary safety precautions. The most egregious case is the beef sector. China joined other countries in closing its market to U.S. beef imports in 2003 due to one discovered case of BSE (bovine spongiform encephalopathy, or "Mad Cow Disease").* But China kept its ban in place even after the United States was classified as a "controlled risk" country by the World Organization of Animal Health in July 2007 and as a "minimal risk" in May 2013.⁸⁰ Likewise, U.S. pork was subject to unjust bans in April 2009, under the pretext of an H1N1 virus outbreak, even though the virus is not transmitted by consumption of food products. China's Ministry of Agriculture and the General Administration of Quality Supervision, Inspection and Quarantine only removed the bans in December 2009.⁸¹

Another form of sanitary restrictions relates to residue levels. It is common for food products to contain some residual level of antibiotics, pesticides, or other potentially harmful substances. In order to facilitate trade, most trade partners agree on allowable maximum residue levels. Residues at low levels pose minimal health risks, according to international agreements. But China has adopted a zero-tolerance approach to ractopamine, a feed ingredient that significantly enhances yield and efficiency in pork production. The

* BSE (bovine spongiform encephalopathy) is a progressive neurological disorder of cattle that results from infection by an unusual transmissible agent called a "prion." The nature of the transmissible agent is not well understood. According to the USDA, the United States has registered four cases of BSE in 2003–2012. The case that first caused the bans on U.S. beef was recorded in December 23, 2003, in an adult Holstein cow from Washington State. On June 24, 2005, the USDA announced receipt of final results from the Veterinary Laboratories Agency in Weybridge, England, which confirmed the first endemic case of BSE in a 12-year-old Texas cow. On March 15, 2006, the USDA confirmed BSE in a ten-year-old cow in Alabama. On April 24, 2012, the USDA confirmed a BSE case in a ten-year-old dairy cow in California. U.S. Department of Health and Human Services, "BSE (Bovine Spongiform Encephalopathy, or Mad Cow Disease)" (Atlanta, GA). <http://www.cdc.gov/ncidod/dvrd/bse/>.

U.S. Food and Drug Administration (FDA) approved ractopamine as early as December 1999, and it is now approved by 26 countries, including several countries in Asia.* The Codex Alimentarius Commission reaffirmed the safety of ractopamine by adopting maximum residue level standards in July 2012.⁸² Given that codex determinations serve as a basis for the WTO rules on dispute resolution, China's zero-tolerance policy is inconsistent with its WTO commitments. China began blocking shipments from individual U.S. pork plants after it detected ractopamine in 2006. The issue was raised in 2009–2011 at working group meetings of the Joint Commission on Commerce and Trade, one of the main bilateral dialogue mechanisms between the United States and China. The United States requested that China adopt an interim maximum residue level for ractopamine. Still, China refused, and following the 2012 codex ruling did not take any steps to address its zero-tolerance policy.⁸³

Sanitary restrictions have had a considerable impact on U.S. livestock producers. The U.S. Meat Export Federation estimated in 2012 that the decade-old ban on U.S. beef cost producers as much as \$350 million a year.⁸⁴ The blow has been mitigated somewhat by huge gray markets that transship U.S. beef products through Hong Kong and other neighboring jurisdictions into China, to be sold at a markup price to wealthy diners and shoppers.† But that has not made up for the loss in market share. Australia, a U.S. competitor that is allowed to export its beef to China, saw its exports rise an incredible 1,948 percent year-on-year in the first half of 2013.‡

The barriers have also hurt pork producers, who rely on fixed rearing and slaughtering cycles and hope for predictable demand and prices. For instance, China's decision in March 2012 to disallow third-party audits of ractopamine in U.S. pork suddenly prevented a host of U.S. pork exports from going to China. According to Mr. Miller, that effectively cut the price of Iowa's 30 million hogs by \$10 per head.⁸⁵ Another factor that makes compliance with the ractopamine ban difficult is that it interferes with the complex segmentation of pork products. As Secretary Northey noted, the United States sends more pork pieces, such as offal, to China than

*As a part of the Codex Alimentarius process, ractopamine hydrochloride has three times been reviewed by the Joint FAO/WHO Expert Committee on Food Additives (JECFA), which has recommended safety standards that align with those within the approved use countries. The most recent review was for consideration of studies conducted and submitted by China. The JECFA scientific statement noted that: "The Committee concluded that, based on the data provided, including those from the three breeds of pigs in the studies undertaken by the People's Republic of China, and corresponding dietary information, the recommended MRLs [maximum residue levels] are compliant with the ADI [acceptable daily intake] as regards consumption of pig tissues of muscle, liver, kidney and fat. The estimated daily intake is approximately 50% of the upper bound of the ADI for a 60 kg person."

†The presence of this gray market was confirmed by numerous parties during the Commission's July 2013 trip to China. Beef is exported legally to Hong Kong, Vietnam, and the Philippines, then recontainerized and shipped to China. Exporters are allegedly willing to pay an additional fee for this transshipping. Because U.S. storage facilities operators in China refuse to harbor illegal imports, the U.S. beef often ends up stored in Chinese facilities, potentially making the product less safe. Many restaurants in Shanghai that serve U.S. beef carry two sets of books in case the authorities come to check on the beef's country of origin.

‡Although Australia is a major beef exporter, it did not send much beef to China until recently. Australia's traditional markets have been Japan, South Korea, the Middle East, and the United States. In the first half of 2013, however, China imported 62,421 tons of Australian beef, up from 3,048 tons a year earlier. Almost overnight, China became Australia's third-largest export destination for beef. Presentation by the U.S. Meat Export Federation (Shanghai, China, July 26, 2013).

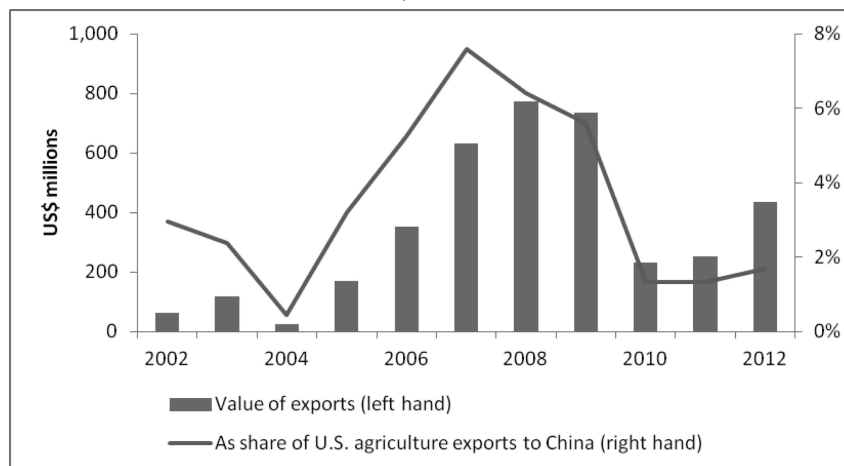
whole hog carcasses. By not using ractopamine in the breeding process, U.S. pork producers incur a higher cost of production for the whole pig. That puts them at a competitive disadvantage when they sell muscle cuts and other parts in the U.S. market.⁸⁶

China's sensitivity to food safety for imports is partly a reaction to the country's internal safety problems. The Chinese government has argued in its defense that it lacks the technology to distinguish harmful from less harmful additives. It has also requested additional research on feed additive residues in the internal organs of pigs, since those parts of the animal are more widely consumed in China than the United States.⁸⁷ Still, as Dr. Gale asserted, China's stringency results in double standards. Although the Chinese government outlaws ractopamine, as well as a dangerous alternative, clenbuterol, countless Chinese pork producers continue to use these additives to increase feed efficiency. According to Dr. Gale, "This brings up an issue of a much tighter enforcement of standards and regulations for imports than in the domestic market," a violation of basic trade principles.⁸⁸ Mr. Brosch argued that "China's strict, and sometimes unsupportable decisions to impose limitations on U.S. imports are driven primarily by internal pressures on its government as a result of past domestic food safety mistakes. In our view, Chinese health officials are now under a tremendous amount of internal pressure and scrutiny and want to appear to their domestic constituents to be increasingly vigilant."⁸⁹

Antidumping Duties and the Tradeoff between Market Access and Food Safety

Antidumping (AD) and countervailing duties (CVD) disputes have been a point of contention in U.S.-China bilateral trade. The agriculture sector is no exception. China's Ministry of Commerce (MOFCOM) imposed AD and CVD duties on U.S. chicken broiler products in August and September 2010, respectively. The AD duties ranged from 50.3 percent to 53.4 percent for the U.S. producers who responded to MOFCOM's investigation notice, while MOFCOM set an "all others" rate of 105.4 percent. In the CVD investigation, MOFCOM imposed countervailing duties ranging between 4.0 percent and 12.5 percent for the participating U.S. producers and an "all others" rate of 30.3 percent. According to the Office of the U.S. Trade Representative, American exports to China of broiler products fell by 80 percent following the application of the duties (see figure 8).⁹⁰

Figure 8: U.S. Poultry Exports to China, 2002–12
US\$ millions



Source: USDA (Washington, DC: Foreign Agricultural Service).

The United States complained to the WTO in September 2011 and was vindicated in August 2013 when a WTO dispute settlement panel found that China's AD/CVD actions against U.S. broiler chickens violated its WTO commitments.* The panel supported nearly all of the U.S. claims, including substantive errors in MOFCOM's calculations and procedures.⁹¹ China decided not to appeal the ruling by the September 10, 2013, deadline.⁹² As a next step, China will have to demonstrate that it has complied with the ruling by repealing the duties. At a September 25 WTO Dispute Settlement Body meeting with Chinese officials, U.S. officials said they hoped the decision would force Beijing to fundamentally reevaluate how it proceeds in AD and CVD investigations.⁹³

Although the WTO decision marked a victory, the AD/CVD actions against broiler products are emblematic of a broader conflict in bilateral trade that is unresolved. China's actions against broiler products coincided with an escalation in other trade disputes. Beijing threatened to impose the duties on chicken in September 2009, weeks after the United States applied a 35 percent tariff on Chinese-made tires.† Within a week of the U.S.'s announcement that it would challenge the tariffs on broiler products, China applied dumping duties on U.S. automobiles and auto parts.‡ The United

* Broiler products include most chicken products, with the exception of live chickens and a few other products such as cooked and canned chicken.

† On September 11, 2009, the president imposed additional duties on imports of certain passenger vehicle and light truck tires from China for a period of three years in order to remedy the market disruption caused by those imports, as determined by the U.S. International Trade Commission (USITC). China challenged the imposition of the duties, alleging that the USITC's determination regarding market disruption and the level and duration of the additional duties were inconsistent with the Protocol of Accession and the General Agreement on Tariffs and Trade (GATT) 1994. A WTO panel later rejected all of China's claims, and the Appellate Body rejected all of China's claims on appeal. Office of the U.S. Trade Representative, "United States Prevails in WTO Dispute about Chinese Tire Imports" (Washington, DC: USTR Press Release, September 2011). <http://www.ustr.gov/about-us/press-office/press-releases/2011/september/united-states-prevails-wto-dispute-about-chinese>.

‡ This is now a separate WTO complaint by the United States. See WTO, "China—Certain Measures Affecting the Automobile and Automobile-Parts Industries" (Geneva, Switzerland: Dispute DS450). http://www.wto.org/english/tratop_e/dispute_e/cases_e/ds450_e.htm.

States also angered China by filing an AD case against Chinese honey in 2000. China's share of U.S. honey imports was around 30 percent when the AD case was initiated, and today that market share is near zero.⁹⁴

Furthermore, the broiler duties were implemented less than two years after Congress passed the DeLauro Amendment, a piece of legislation introduced by Representative Rosa DeLauro (D-OH), chair of the House Appropriations agriculture subcommittee, to the 2008 Farm Bill. The amendment prohibited funding the USDA Food Safety Inspection Service (FSIS) inspection of processed poultry imports from China. China soon challenged the ban in the WTO. The U.S. Trade Representative and the USDA worked with Congress to soften the language of the DeLauro Amendment in the fiscal year 2010 agriculture appropriations bill, opening the door to funding inspections of Chinese-processed poultry if certain conditions could be met by the USDA.⁹⁵ Nonetheless, China did not withdraw its WTO complaint and a year later won the case.⁹⁶ The United States subsequently repealed the amendment. Some U.S. agriculture officials and advocates argue that it left a negative legacy for market access negotiations, particularly in regard to China's bans on U.S. beef. Owing to the USDA's dual functions as a trade negotiator and food safety inspector, certain Chinese officials apparently believe that the agency is capable of influencing U.S. food safety legislation in return for greater market access in China.⁹⁷

U.S. interest groups are divided about the merits of curbing Chinese food imports through legislation such as the DeLauro Amendment. For Patty Lovera of Food & Water Watch and other food safety advocates, U.S. food consumers need to be protected from China's unsafe production and weak regulation. According to this argument, China does not deserve an "equivalence determination," under which its food safety process would be deemed equivalent to the USDA's standards. The USDA audits prospective meat processing plants in China and approves those that meet its standards but then only visits them on a periodic basis for auditing purposes.⁹⁸ In the United States, a USDA inspector is always present at each plant. For food safety advocates, these regulatory procedures do not sufficiently guarantee the safety of Chinese poultry imports (See Food Safety section below for more discussion of food safety inspection.)⁹⁹

On the other hand, poultry industry advocates argue that the U.S. government has committed a grave error in interfering with bilateral poultry trade. U.S. agribusinesses have invested heavily in Chinese chicken production and processing—both to feed Chinese consumers and as a future export platform to U.S. consumers—and they have been working to get USDA approval for Chinese poultry exports to the United States. These advocates argue that USDA-FSIS approvals and equivalency procedures of

⁹⁴According to a spokesperson at the time, Rep. DeLauro agreed to the amended bill in part because it requires that the USDA: (1) increase inspections and audits of Chinese poultry processing plants once they are certified; (2) make public the list of eligible plants and the outcomes of audits of those plants; and (3) not rush to an equivalency determination for the safety of China's poultry slaughter operations, which are to be subject to a separate approval process from poultry processing. *Inside U.S.-China Trade*, "Compromise Reached on Poultry Ban, Could End U.S.-China WTO Dispute," September 30, 2009, via Factiva database.

Chinese exporting plants are sufficiently stringent, as the United States currently permits poultry imports from only three other countries—Costa Rica, Canada, and Chile. The DeLauro Amendment, they argue, refuses USDA-FSIS the funding to even do its job. By targeting China, it also violates the U.S.'s WTO commitments and sets a bad example for unilateral action against a single trade partner in the WTO system. They further assert that very little processed poultry will be imported, as China has no commercial advantage in this market segment.¹⁰⁰

On September 5, the USDA-FSIS reaffirmed the equivalence of China's food safety inspection system for processed poultry, which was originally established in 2006. That will enable China to certify plants to export processed poultry products to the United States. The raw poultry used for these products must originate in the United States and Canada, as the USDA-FSIS has yet to provide equivalency status for slaughtered poultry in China. Nevertheless, the decision lays the foundation for negotiating future exports of processed poultry using Chinese-origin birds.¹⁰¹

State Trading and Domestic Supports

Another means by which China has restricted the flow of trade in agriculture is by requiring state trading* and providing domestic supports. These policies have done particular damage to U.S. exports of land-intensive crops and meat products. State trading impacts the allocation of tariff-rate quotas. Tariff-rate quotas function as a way of protecting a market from excessive imports and, at the same time, provide a means of liberalizing trade and breaking up monopolies by dividing up the quota among different traders and passing on unfilled quotas. Following WTO accession, China's trading monopoly China National Cereals, Oils and Foodstuffs Corp. agreed to reduce its exclusive rights by allocating some quotas to other traders in a transparent manner.¹⁰²

However, China has been reluctant to comply with these commitments. In 2002, the National Development and Reform Commission, the Chinese agency in charge of implementing the regulations, refused to provide details on amounts and recipients of allocations. It also reserved a significant portion of tariff-rate quotas for the processing and reexport trade instead of the import-competing sector. By 2004, tariff-rate quotas improved after considerable U.S. pressure through the Joint Commission on Commerce and Trade negotiations. Nevertheless, state-owned enterprises still dominate bulk commodity trading, accounting for an estimated 90 percent of the wheat quota, 60 percent of the corn quota, 50 percent of the rice quota, 70 percent of the sugar quota, and 33 percent of the cotton quota. One way that China achieves this is by maintaining stringent licensing requirements to limit the pool of eligible nonstate firms.¹⁰³

*State trading enterprises are defined as governmental and nongovernmental enterprises, including marketing boards, which deal with goods for export and/or import. Article XVII of the General Agreement on Tariffs and Trade (GATT) 1994 is the principal article dealing with state trading enterprises (referred to as "STEs") and their operations. It sets out that such enterprises—in their purchases or sales involving either imports or exports—are to act in accordance with the general principles of nondiscrimination and that commercial considerations only are to guide their decisions on imports and exports. It also instructs that members are to notify their state trading enterprises to the WTO annually. World Trade Organization (Geneva, Switzerland). http://www.wto.org/english/tratop_e/statra_e/statra_e.htm.

Further, Beijing has leveraged its extensive state control over commodity import decisions as a tool of economic diplomacy. In December 2003 and February 2012, then Premier Wen Jiabao and then Vice President Xi Jinping negotiated landmark soybean acquisition deals during state visits to the United States. In both cases, the acquisitions were timed as a “feel-good” deliverable to offset U.S. concerns about the bilateral trade deficit.¹⁰⁴

While China has agreed to minimize subsidies to meet its WTO commitments, it has found ways to support farmers and processors by subverting the rules. One example is its discriminatory use of the value-added tax (VAT) levied on industry. China signed on to the Article III of the General Agreement on Tariffs and Trade (GATT), which explicitly states, “WTO members shall not be subject, directly or indirectly, to internal taxes or internal charges of any kind in excess of those applied directly or indirectly to [a] like domestic product.” In fact, China has not complied with this commitment. In 2009, USDA-funded research found that China imposes a 13 or 17 percent VAT on food and agriculture imports, while China’s own farmers and meat producers use a complex rebate system in order to pay almost no VAT at all.* Stated Veronica Nigh of the American Farm Bureau Federation: “The effect of many of China’s VAT rebate adjustments is to make larger quantities of primary and intermediate products in a particular sector available domestically at lower prices than the rest of the world, giving China’s downstream producers the finished products using these inputs a competitive advantage over foreign downstream producers.”¹⁰⁵

The VAT tax is one of the reasons why value-added production has been transferred from the United States to China. Soybeans, the top U.S. agricultural export, are shipped primarily in bulk form instead of processed feed. According to Iowa Secretary of Agriculture William Northey, China’s domestic soybean crushing industry has expanded rapidly, to the extent that it now has 40 to 50 percent overcapacity.¹⁰⁶ Foreign investment has contributed to this capacity buildup—foreign agribusiness firms, including Archer Daniels Midland, Bunge, and Cargill, own about 70 percent of China’s soybean crushing industry.¹⁰⁷ Some of this production is also ending up on world markets: statistics compiled by the United Nations (UN) Food and Agriculture Organization show that China’s exports of feed, meal, and gluten increased by 63 percent a year in 2001–2011, while U.S. exports declined by 8 percent per annum over the same period. U.S. market share in this trade category declined from 79 percent to 43 percent in 2001–2011.¹⁰⁸

The Office of the U.S Trade Representative affirms that agriculture is just one of several sectors in which China has used discriminatory taxation to gain a competitive edge:

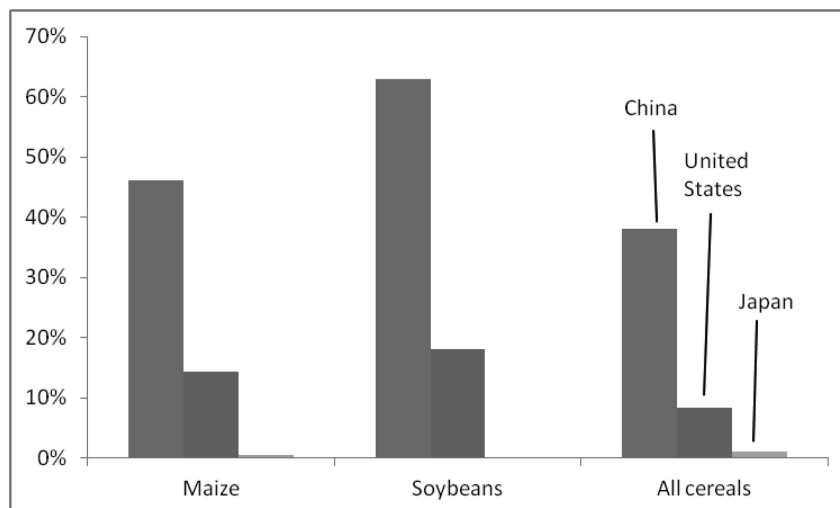
*Slaughterhouses and food processors, for example, are given major deductions from the nominal VAT, as they are permitted to “impute” a VAT paid at prior stages of production. The differential VAT rates charged for domestic producers and imports thus constitute a clear violation of Article III of the General Agreement on Tariffs and Trade (GATT) 1994. U.S. Trade Representative, *Hearing on China’s Compliance with World Trade Organization Commitments*, written testimony of National Pork Producers Council, September 24, 2012; and U.S. Grains Council, *National Trade Estimates Report Submission* (Washington, DC: October 12, 2012), p. 17.

*China's economic planners attempt to manage the export of many primary, intermediate and downstream products by raising or lowering the value-added tax (VAT) rebate ... these border tax practices have caused tremendous disruption, uncertainty and unfairness in the global markets for the affected products—particularly when these practices operate to incentivize the export of downstream products for which China is a leading world producer or exporter.*¹⁰⁹

China has also been able to provide billions of dollars in agriculture subsidies through a series of loopholes. One such loophole is how China defines the “value of production.” Farm support under the WTO’s de minimis provision is measured as a share of total production value. Agricultural production, according to the Chinese government’s questionable statistics,¹¹⁰ has been expanding at a significant 12 percent a year. Thus, subsidies can be very large in nominal terms but appear small relative to production.¹¹¹

A related form of farm support is China’s procurement and stockpiling of commodities to subsidize domestic producers and offset market prices.¹¹² For nearly all major staple crops, China holds an outsized share of global stockpiles (see figure 9).¹¹³ China has adopted a particularly aggressive stockpiling policy toward three of the largest U.S. exports to China: soybeans, corn, and cotton. The stockpiles are derived not only from imports but also domestic production. In 2008, in view of the rapid price increases and fluctuations of soybeans on the global market, the National Development and Reform Commission began to procure domestic soy at above the world market price, thus establishing a reserve stockpile and also boosting the income of its soy farmers. China announced last year that it would stockpile soybeans for a fifth year running.¹¹⁴ China’s latest No. 1 Document, released in January 2013, lays out policies to raise the minimum purchase prices for wheat and rice; stockpile corn, soybeans, and other crops; and adjust export and import duties as necessary to achieve food (grain) security.¹¹⁵

Figure 9: China, U.S., and Japan's Share of Surplus Stockpiles of Key Commodities, 2012
Share (%)



Note: Stockpiles are calculated based on what a country produces, consumes, and trades. The surplus left over at the end of each year is the stockpile.

Source: Food and Agriculture Organization, *Agricultural Market Information System* (Rome, Italy: Agriculture Market Information System Secretariat). <http://statistics.amis-outlook.org/data/index.html#>.

According to testimony from Mark Lange, the president of the U.S. National Cotton Council, China's subsidies to its domestic cotton industry are having a negative impact on U.S. cotton exports, which account for 14 percent of U.S. agricultural exports to China. China in recent years began procuring cotton from its domestic producers for a rate far above world market prices. That has actually hurt China's textile mills, which are forced to buy expensive cotton and are barred by import licensing quotas from increasing imports of cheaper cotton from the United States. The mills are thus turning to manmade synthetic fibers, in turn boosting China's chemical industry. This policy has affected U.S. cotton exports to China, as well as introducing considerable uncertainty into the industry, as cotton prices could plummet once China releases its stockpiles onto the world market.¹¹⁶

In the pork sector, the U.S. National Pork Producers Council recently estimated that U.S. pork exports to China would increase by 50 percent if China eliminated its domestic pork subsidies. Pork subsidies rose substantially following an outbreak of swine disease that reduced China's pork production in 2007 and 2008. In January 2009, the Chinese government introduced a price support scheme for pork called the "National Price Alert and Subsidy Program." The program is based on the ratio between China's live hog and corn prices: when the hog-corn price ratio falls below a certain range—either because pork is too cheap or corn too expensive—the government procures pork from the domestic market at generous prices to support pork farmers. Related policies include hog and

pork stockpiling; a sow insurance program; and a cash subsidy scheme for large-scale breeding farms.¹¹⁷

China's Agribusiness Development and Regulation of Foreign Investment

Restricted Access for U.S. Firms in China's Agriculture Sector

The United States has helped China in diverse ways to develop its agriculture sector. During its July 2013 trip, the Commission met with representatives of Archer Daniels Midland Company, Cargill China, Preferred Freezer Services, and other U.S. companies that have built state-of-the-art production, processing and storage facilities on the Mainland. Cargill China and OSI Group have recently established vertically integrated poultry breeding facilities by consolidating land from local farmers. U.S. companies hire thousands of employees in China and, in some cases, finance training at their facilities in the United States.¹¹⁸ U.S. food retailers, led by Yum! Brands, Inc. and McDonald's Corp., have transferred best practices in the food service industry. These private sector efforts are being reinforced by technical assistance programs administered by U.S. government agencies and U.S. universities. The United States and China have launched more than 500 science and technology exchange programs since they established the working group on agricultural science and technology cooperation in 1980, with around 3,000 experts involved. In 2011, the two sides held the fourth meeting of the China-U.S. Joint Commission on Agriculture, which developed guidance to the two working groups on agricultural sciences and biotechnology.*

However, in spite of these supportive efforts, U.S. companies have not been granted fair market access in China. A pervasive problem is regulatory uncertainty, in the form of state-run media campaigns targeting foreign brands; stricter oversight than for domestic companies; and corrupt practices by officials at the local level.† U.S. companies are required to enter into joint ventures with Chinese companies as a condition for investing in certain sectors.‡ Although this requirement per se does not violate China's WTO commitments, it often benefits China's state-owned enterprises. For example, Coca-Cola's joint venture partner in China is a subsidiary of China National Cereals, Oils and Foodstuffs Corp., the same conglomerate that dominates China's state trading of

* The Commission, on its July 2013 China trip, met with faculty from the Northwest Agriculture and Forestry University, one of China's top agronomics faculties based in Shaanxi Province, who discussed their partnerships with the University of California-Davis and other U.S. universities. Xinhua China Economic Information Service, "China to Deepen Agricultural Cooperation with U.S.," February 12, 2012, via Factiva database.

† A more optimistic assessment of these problems, voiced by some businesses, is that foreign companies serve as models for the rest of industry and are chosen by Chinese officials to experiment with new policies, such as environmental and food safety standards. U.S. companies, meetings with Commissioners, Shanghai, China, July 25–26, 2013.

‡ The relevant rules for joint ventures are laid out in the Catalogue of Industries for Guiding Foreign Investment that was first introduced by the State Council in 1995 and last revised in 2011. The catalogue comprises over 450 industries. In nearly 100 of those industries, foreign investment is subject to ownership restrictions. About half of those restrictions require foreign investors to form joint ventures—equity, cooperative, or contractual—with Chinese partners. State Council, "Waishang touzi chanye zhidao mulu (2011 nian xiuding)" (Catalogue of Industries for Guiding Foreign Investment—2011 Revisions) (Beijing, China: 2011). http://www.gov.cn/fjfg/2011-12/29/content_2033089.htm.

commodities.¹¹⁹ And although restrictions on foreign investment have been relaxed, major investments still require approval from the Chinese government. In 2009, for instance, China invoked its new antitrust law to prevent Coca-Cola from purchasing the juice maker Huiyuan Juice.¹²⁰ Several sectors of China's economy are in fact off-limits to foreign companies; in the agriculture sector, foreign companies are prohibited from buying land; investing in the production of transgenic plant seeds; and constructing and operating large-scale wholesale markets for agricultural products.¹²¹

U.S. companies are also anxious about guarding their intellectual property in China. Barbara Glenn, vice president of Science and Regulatory Affairs at CropLife America, told the Commission that U.S. agrochemical and seed companies in China have encountered counterfeit goods as well as unauthorized misappropriation of trade secrets that are used to produce infringing products. These practices discourage U.S. agrochemical firms from investing in research and development in China and from deploying their most cutting-edge products there.¹²²

Further, U.S. developers of biotechnology are concerned about China's regulatory approval process. For the majority of these companies, which invest heavily in genetically modified seeds, China has become central to their business model, because their customers produce crops for export to China. At present, China only begins the approval process for a foreign biotechnology event when that event has already been approved in the exporting country. Ideally, both countries would conduct the approvals at the same time in order to expedite the process. This system of "asynchronous approvals" has become a pressing concern for U.S. agribusinesses.¹²³ Julius Schaaf, vice chairman of the U.S. Grains Council, told the Commission:

*Among the most important factors affecting the near term evolution of U.S. exports of corn is the regulatory treatment of biotechnology. . . . As the importance of biotech crops continues to increase globally, potential disruptions due to inconsistent and sometimes unpredictable national treatment have become a recurring concern. With regard to China, the asynchronous approval process for biotech events is of particular importance.*¹²⁴

China's Agribusinesses and Outbound Investment

In parallel to restricting market access for foreign agribusinesses, Beijing is fostering its own "state champions" to consolidate the agriculture sector. China's leading state-owned agribusiness, China National Cereals, Oils and Foodstuffs Corp., has extended its business from the grain trade to diverse activities along the value chain, from grain crushing to livestock production and beverage making. Meanwhile, quasi-private firms are expanding, especially in the livestock industry. These include Shuanghui Group, China's largest pork producer. The company began as a meat processing plant under a municipal government in Henan Province, in the interior of China. As recently as 2004, Shuanghui Group was taken over by a municipal branch of the government's State-Owned Asset Supervision and Administration Commission, an agency charged

with restructuring state-owned enterprises. In 2006, the government divested its interest in Shuanghui Group, selling to a consortium led by Goldman Sachs and CDH, a Chinese private equity fund. Nonetheless, Shuanghui's current chairman, Wan Long, has stayed in charge throughout this "privatization" process. He is a longtime member of China's Communist Party and National People's Congress. Through a management buyout in 2010, he has been able to exercise majority control over the company's shares and voting rights.¹²⁵ The Chinese private equity firm New Horizon Capital—cofounded by former premier Wen Jiabao's son Wen Yunsong—is a minority shareholder of Shuanghui.*¹²⁶

China's agribusinesses have pursued outbound investment in several countries and sectors (see figure 10). According to Dr. Gale, government policy influences these outbound investments. Of note is what Dr. Gale refers to as the "two markets, two resources" strategy, which "calls for control of overseas farm production, processing and logistics by Chinese companies for commodities that cannot be supplied domestically." The premise is that supply chain control will give Chinese companies a greater cost and price advantage in global markets. The "two markets, two resources" strategy is manifest in a plan, issued by the National Development and Reform Commission, that designates companies for overseas ventures. The two flagship companies chosen to shore up vegetable oil supplies, for instance, are Chongqing Grain Group and Beidahuang, an agribusiness company created by the Heilongjiang Province state farm system. These two companies have plans to invest in soybean and rapeseed production, processing, and logistics in Brazil, Russia, and Canada. Reportedly, Chongqing Grain Group has already begun importing soybeans from its Brazil project. Similarly, China National Cereals, Oils and Foodstuffs Corp. and other state-owned enterprises are to invest in soybean, cassava, rubber, and sugar projects. The strategy is financed by earmarked loans from state banks and public offerings in equity markets.¹²⁷ Tax breaks have supported agribusiness growth as well: Article 27 of China's Enterprise Income Tax Law provides that income generated from agriculture, forestry, husbandry, or fisheries may be exempted from the tax.¹²⁸

*New Horizon is a private equity group cofounded by Wen Yunsong, the only son of former premier Wen Jiabao. According to the *Financial Times*, Wen Yunsong "has been an active participant in Chinese investment since earning an MBA at Kellogg management school at Northwestern University in the US." New Horizon's first fund was incorporated in the Cayman Islands in 2005 with \$100 million. A primary contributor to that first fund was Temasek, Singapore's sovereign wealth fund. New Horizon closed its second fund in May 2007 with \$500 million. The *Financial Times* reported in January 2010 that New Horizon was close to raising \$1 billion from foreign investors for a fund that will invest in Chinese enterprises on the Mainland. Among the contributors to the latest fund are U.S. and European institutions. In addition to Shuanghui, New Horizon's equity investments include Xinjiang Goldwind, China's largest wind power equipment maker, and Zoomlion, China's second-largest construction machinery maker. Jamil Anderlini, "China Premier's Son Nears \$1bn Target for Fund," *Financial Times*, January 27, 2010, via Factiva database; U.S. Senate Committee on Agriculture, Nutrition, and Forestry, *Hearing on Smithfield and Beyond: Examining Foreign Purchases of American Food Companies*, testimony of Usha Haley, 113th Cong., 2nd sess., July 10, 2013.

Figure 10: Outbound Investments by Chinese Firms in the Food Sector, 2008–2012

Year	Month	Investor	Investment (\$ millions)	Subsector	Country	Type	Share Size	Partner/Target	Land Acquisition
2012	Dec.	Yili Industrial	\$210	Dairy	New Zealand	Equity	100%	Oceania Dairy	No
2012	Nov.	Shanghai Zhongfu	\$730	Sugar	Australia	Greenfield	—	—	Yes
2012	Sept.	Synutra	\$120	Dairy	France	Joint venture	—	Sodiaal	No
2012	Aug.	Complant	\$170	Sugar	Jamaica	Equity	100%	State-owned sugar plants	Yes
2012	May	Bright Foods	\$1,940	Consumer foods	Britain	Equity	60%	Weetabix	No
2012	Apr.	Shanghai Pengxin	\$170	Dairy	New Zealand	Equity	100%	Crafar Farms	Yes
2011	Aug.	Bright Foods	\$390	Consumer foods	Australia	Equity	75%	Manassen Foods	No
2011	July	COFCO	\$140	Sugar	Australia	Equity	99%	Tully Sugar	Yes
2011	June	Heilongjiang Beidahuang Nongken	\$1,510	Soybeans	Argentina	Joint venture	—	Cresud	Yes
2011	March	Chongqing Grain	\$1,410	Soybeans	Brazil	Greenfield	—	—	Yes
2010	Oct.	Sinochem	\$1,440	Agrochemicals	Israel	Equity	60%	Makhteshim-Agan	No
2009	July	CIC	\$370	Consumer foods	Britain	Equity	1%	Diageo	No
2008	June	China National Cereals, Oils and Foodstuffs	\$140	Pork	USA	Equity	5%	Smithfield Foods	No

Sources: “China Global Investment Tracker” (Washington, DC: Heritage Foundation, July 2013). <http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map>; various media sources.

In the United States, China’s outbound investments came into focus in June 2013, when Shuanghui International Holdings Limited, a subsidiary of Shuanghui Group, proposed to acquire Smithfield Foods Inc., the largest U.S. pork producer. The deal, valued at \$7.1 billion, is the largest-ever acquisition of a U.S. company by a Chinese company. It raises several critical issues. First, Smithfield is the market leader in the U.S. pork industry, and thus acts as a strategic node in the U.S. pork supply chain (see table 2).

Table 2: Top-Ten Pork Producers in the United States by Sows and Slaughtering Capacity

	Sows (2012)			Daily slaughter capacity (2009)	
	Sows	Market share		Slaughter capacity	Market share
1 Smithfield	862,000	28.4%	1 Smithfield	126,300	28.4%
2 Triumph	378,500	12.5%	2 Tyson	74,550	16.8%
3 Seaboard	217,000	7.1%	3 Swift	47,000	10.6%
4 Maschhoffs	196,000	6.4%	4 Excel	38,500	8.7%
5 Prestage Farms	165,000	5.4%	5 Hormel	37,000	8.3%
6 Iowa Select Farms	160,000	5.3%	6 Seaboard	19,200	4.3%
7 Pipestone System	145,000	4.8%	7 Excel	19,000	4.3%
8 Cargill	136,000	4.5%	8 Indiana Packing Co.	16,500	3.7%
9 Carthage System	103,500	3.4%	9 Hatfield	10,600	2.4%
10 AVMC Management Services	82,000	2.7%	10 J.H. Routh	4,200	0.9%
Other	593,800	19.5%	Other	52,075	11.7%
TOTAL	3,038,800		TOTAL	444,925	

Source: Top U.S. Pork Powerhouses, 2012. <http://www.agriculture.com/uploads/assets/promo/external/siteimages/PP2012.pdf>.

Second, the deal is not guaranteed to improve overall market access for U.S. pork in China. China is unlikely to abandon its policy of self-sufficient meat production. A more likely result is a closed market of intracompany trade between Shuanghui and Smithfield, combined with U.S. soybean and corn imports to feed China's hogs. Given Smithfield's massive output, it could supply the bulk of China's limited imports of U.S. pork. Indeed, Smithfield has developed a special relationship with Shuanghui over several years. At its plant in North Carolina, the largest of its kind in the world, Smithfield already switched over to ractopamine-free pork production at Shuanghui's request, prior to the proposed acquisition.¹²⁹ Meanwhile, other pork plants in the United States could still find it tough to export to China, either because the costs of complying with ractopamine restrictions are too high or because they do not enjoy the privileges of a firm owned by a Chinese parent company.

Third, even if China does import more U.S. pork, U.S. meat slaughterers and processors could lose out. Under the 12th Five-Year Plan (2011–2015), China has begun to consolidate and industrialize its meat industry. It is shutting down backyard farms in favor of large, vertically integrated operations. Although technically in private hands, Shuanghui is crucial to the government's efforts to enact this policy. The problem for Shuanghui is that it has built large industrial facilities to slaughter and process pork but lacks the hogs to fill them. Without direct control over hog farms, it sources meat from smaller producers, which leads to erratic quality and output. Importing pig carcasses from Smithfield appears to be an expedient solution. Shuanghui might use Smithfield mainly as a supplier of hog carcasses. Usha Haley told the U.S. Senate Committee on Agriculture, Nutrition, and Forestry:

Extrapolating from what has occurred in steel, paper, glass, auto parts and solar, the United States will become an exporter of the commodity of pork to China, and an importer of higher-value-added processed foods from China. ... Although U.S. exports to China of pork will rise, U.S. imports of processed foods from China will rise even faster, contributing to the trade deficit and loss of manufacturing

*capacity. . . . U.S. companies would be unable to compete domestically and in exports against a Shuanghui-Smithfield that does not pursue profits but is heavily subsidized and aims for industry domination.*¹³⁰

Fourth, while Smithfield could become a “raw material” supplier to Shuanghui, it would also transfer substantial intellectual property and branding power to its Chinese parent. Technology transfer* is a salient trend in China’s pork industry. Along with consolidation and capacity expansion, the Chinese government is seeking better technologies to improve the productivity of its livestock. According to *Delta Farm Press*, a respected agriculture publication in the United States, China is “capitalizing on decades of cutting-edge U.S. agricultural research.”¹³¹ Chinese producers are especially looking to forge uniform herds based on the most efficient breeds, like Duroc, Yorkshire, and Landrace.¹³² From 2002 to 2007, China imported a total of 13,000 head of swine; from 2008 to 2011, live swine imports totaled 39,000 head—15,000 in 2011 alone.¹³³ In 2002-2012, China increased its share of U.S. live swine exports from 5 percent to 51 percent.¹³⁴

Finally, an irony not lost on opponents of the Smithfield acquisition is that, if the situation were reversed, China’s laws on foreign acquisitions would allow the government to block the sale on economic and commercial grounds rather than just national security, as is the case with the U.S. laws. Stated Dr. Haley: “As the Chinese government views pork-processing as a strategically important industry, the country is unlikely to open this market to U.S. companies.”¹³⁵

Shuanghui and Smithfield submitted their proposed transaction for approval to the Committee on Foreign Investment in the United States (CFIUS) in June. On September 6, the companies received clearance from CFIUS.¹³⁶ The shareholders voted September 24 to approve the sale. The transaction is expected to become final toward the end of 2013.¹³⁷

Food Safety: China’s Penetration of the U.S. Food Chain

The Safety of U.S. Food Imports from China

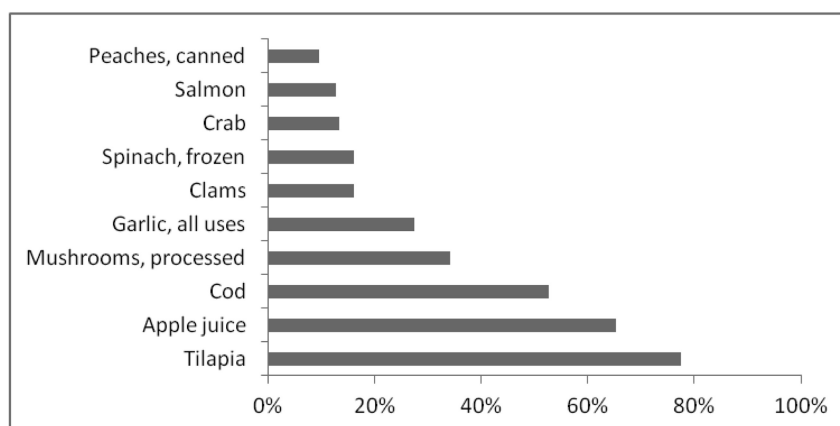
China’s WTO accession was primarily envisaged as an opportunity for U.S. exporters. But U.S. food imports from China have surged as well, part of a greater reliance on imported food by U.S. consumers.† Food imports from China tripled to 4.1 billion pounds

*Owing to its vertically integrated operations, Smithfield has played a pioneering role in modernizing breeding techniques for U.S. hog farms, competing head-on with dedicated genetics and breeding companies. The Smithfield Lean Generation Pork™ Program has been among the nation’s leading fresh pork programs, with dozens of branded items in its product line. Already in the 1990s, Smithfield acquired long-term rights for the NPD hog, a breeding line developed by National Pig Development Co., a British firm. In 2000, it bought out the U.S. branch of NPD, forming an in-house unit to undertake research and development. This intellectual property will be transferred to Shuanghui.

†The U.S. Government Accountability Office (GAO) reports that from 2000 through 2011, the percentage of food consumed in the United States that was imported rose from 9 percent to over 16 percent, and food imports increased by an average of 10 percent each year for seven years. “According to the U.S. Department of Agriculture’s Economic Research Service, the food groups with the highest share of imports are fresh fish and shellfish (85 percent in 2009) and fruits and nuts (38 percent in 2009).” U.S.-China Economic and Security Review Commission, *Hearing on China’s Agriculture Policy and U.S. Access to China’s Market*, testimony of Patty Lovera, April 25, 2013.

in 2001–2012 and have reached a high level of penetration for specific products (see figure 11). The majority of imports consists of consumer-oriented products. For these products, the United States accumulated a trade deficit of \$5 billion with China in 2008–2012. About a third of U.S. food imports from China are fresh, frozen, and processed fish and seafood products. Another 41 percent is comprised of fruits and vegetables, products that often compete directly with U.S. producers.¹³⁸

Figure 11: Imports from China as Share of U.S. Consumption
Four-Year Average, 2008–2011, share (%)



Sources: USDA, *GATS* [General Agreement on Trade in Services] *Database* (Washington, DC: Foreign Agricultural Service); USDA, *Vegetable and Melon Yearbook 2011* and *Fruit and Tree Nut Outlook* (Washington, DC: Economic Research Service, 2012); and U.S. National Fisheries Institute, “Top 10 Consumed Seafoods,” 2012, via U.S.-China Economic and Security Review Commission, *Hearing on China’s Agriculture Policy and U.S. Access to China’s Market*, testimony of Patty Lovera, April 25, 2013.

Imports from China also comprise a host of processed foods and food ingredients whose provenance may be less obvious to U.S. consumers. Food ingredients include xylitol, used as a sweetener in candy; ascorbic acid, a preservative; and vitamin ingredients, like folic acid and thiamine, frequently added to food products. Processed food imports, in turn, include vitamin C, candy, condiments, pet food, and pasta and baked goods, as well as food supplements and even gel capsules and nonactive pill binders for pharmaceuticals.¹³⁹

For the United States, these imports from China present significant food safety risks. Over the past decade, China’s major trade partners have repeatedly banned its food shipments on the basis of food safety. The earliest actions centered on seafood—the European Union and the FDA temporarily blocked imports of shrimp, crayfish, and crabmeat from China in 2002–2004 after discovering high residue levels of chloramphenicol, a broad spectrum antibiotic drug used to treat life-threatening infections in humans.¹⁴⁰ China’s food product safety garnered wider attention in 2007, when excessive antibiotic and pesticide residues led several countries, including South Korea, Japan, and the European Union, to impose renewed bans.¹⁴¹ The most imminent threat to the United States at the

time was pet food from China that contained a harmful industrial solvent, melamine. The FDA received reports of 17,000 pet illnesses, including 4,000 dog and cat deaths, believed to be the result of melamine contamination in imported Chinese gluten used to make pet food. Sixty million packages of melamine-contaminated pet food were recalled. That did not prevent a portion of melamine-contaminated products from ending up in other U.S. food products; there were reports that 56,000 hogs ate melamine-tainted pet food and were processed into pork, which was then sold at supermarkets.¹⁴² The melamine threat did not end there. In the fall of 2008, the FDA also recalled candy made by U.S. companies in China due to concerns of melamine contamination in Chinese milk.¹⁴³ The FDA in June 2012 and June 2013 twice extended bans on milk products from China, which included chocolate products.¹⁴⁴

China's Organic Food Exports to the United States

China has become a supplier of organic foods to the U.S. market. According to the USDA's National Organic Program, from 1995 to 2006, the value of organic food exported from China rose from \$300,000 to \$350 million annually. By 2010, 649 operations in China were certified by the USDA as meeting U.S. organic standards.¹⁴⁵ Ironically, these imports now include organic soybeans. Because organic livestock producers in the United States cannot use the genetically modified soybeans harvested at home, they are turning to China's nongenetically modified beans instead.¹⁴⁶

Organic foods are generally characterized by methods of farming that do not involve synthetic inputs such as chemical fertilizers. In China bureaucratic infighting has led to the emergence of two competing standards for organic food. The Ministry of Agriculture has promoted a less rigorous "green food" standard since the early 1990s, which comprises foods that have very low levels of chemical residues. The Environment Ministry, in turn, adheres to a more rigorous "organic food" standard, which requires that food products contain no chemical residues at all. To encourage organic food exports, China has lobbied to make these standards equivalent with those of developed country markets like the United States, the European Union, and Japan. At present, however, neither standard has achieved international recognition.¹⁴⁷

The USDA issues its own approvals for organic food produced in China. It does so by accrediting private, third-party certifiers. Once these certifiers approve a Chinese production facility, that facility's products are "USDA certified" and can be sourced by Whole Foods and other organic food retailers in the United States. Some experts assert that the USDA has exhibited a lack of due diligence in issuing certain approvals. USDA officials three years ago visited China to conduct an audit of four of the ten companies it had accredited as organic food certifiers. The officials reported that conditions "pose challenging oversight duties and responsibilities for certifying agents operating in China." They

**China's Organic Food Exports to the United States—
Continued**

discovered, for instance, that a certifier had used Chinese government employees to inspect state-controlled farms, suggesting a direct conflict of interest among different actors in China's government.¹⁴⁸

Inadequate Food Safety Regulation in China

Current regulation of food entering the United States from China is insufficient. First of all, the Chinese government's own food safety regulation is inadequate. Multiple agencies oversee the food safety regulation process, including the Ministry of Health; the Ministry of Agriculture; the Ministry of Commerce; and importantly, the General Administration of Quality Supervision, Inspection, and Quarantine, which has separate jurisdiction over customs inspections. In the United States, there is no separate agency for customs. The various Chinese agencies also have central and local branches, forming a fragmented and decentralized system of regulation.¹⁴⁹

The Chinese government in 2009 introduced a comprehensive Food Safety Law to establish a modern framework for food safety regulation. The law was partially successful in handing more oversight power to the Ministry of Health and creating an intraministerial working group. This regulatory consolidation was reinforced in March 2013, when the government created a new China Food and Drug Administration, which took on certain responsibilities from the State Food and Drug Administration; the Ministry of Agriculture; the State Council's Food Safety Committee; and the General Administration of Quality Supervision, Inspection, and Quarantine.¹⁵⁰ The 2009 law also made progress in specifying guidelines for hazard analysis and risk management, in order to track food safety "from farm to plate."¹⁵¹ During its trip to China, the Commission met with officials from the China Food and Drug Administration to learn more about their activities.¹⁵²

However, it is uncertain whether these reforms will make a substantial difference. The consolidation of agencies has stopped short of full integration. For instance, farm-level production and slaughter is still overseen by the Ministry of Agriculture.* Further, the China Food and Drug Administration has just a few hundred staff at the central government level in charge of overseeing tens of thousands of less-capable inspectors in local agencies.¹⁵³ Due to extreme fragmentation of production—with an estimated 450,000 companies in food-processing alone—traceability of food products remains a stiff task.¹⁵⁴

*The China Food and Drug Administration will apparently handle the safety of food production as well as distribution, in contrast to its predecessor, the State Food and Drug Administration, which supposedly handled only safety in the food service industry. In spite of this regulatory integration, the General Administration of Quality Supervision, Inspection, and Quarantine Department remains responsible for customs inspections, while the Ministry of Agriculture remains in charge of overseeing "primary" production, including livestock slaughter. Brady Sidwell (vice president, corporate development, OSI Group), e-mail to Commission staff, July 31, 2013.

Academic research has shown that the 2009 Food Safety Law has done little so far to hold producers and officials accountable. According to John Balzano of Yale Law School, Chinese consumers still have difficulty filing coordinated lawsuits against food companies, and the courts rarely investigate public officials.¹⁵⁵ Other experts have argued that illegal food production occurs in China because local officials are responsible for both economic growth and food safety and, in many cases, prioritize the former.¹⁵⁶ As a result, safe and high-quality food production is not consistently rewarded, while unsafe and low-quality production is not consistently punished.¹⁵⁷ The Chinese government has resorted instead to public displays of enforcing food safety rules, inspecting food facilities, and punishing people connected with tainted food, especially in high-profile cases. In July 2007, for example, the former head of the State Food and Drug Administration was executed on conviction of receiving \$850,000 in bribes.¹⁵⁸ The melamine scandal in 2009 led the authorities to close down half the country's dairies.¹⁵⁹ Two years later, a concerted crackdown on food safety violations resulted in 2,000 arrests and 4,900 businesses being closed. These actions were widely reported in the state media.¹⁶⁰

Problems with U.S. Food Safety Inspection

In the absence of effective regulation by the Chinese government, U.S. consumers depend on U.S. food safety inspectors to do their jobs. And yet, there are numerous problems with U.S. food regulation. The system is fragmented, underfunded, and heavily reliant on third-party verification—structural flaws documented through extensive congressional hearings and government reports.¹⁶¹ The FDA and the USDA divide up food safety inspection by product group, with most seafood, horticulture, and processed foods coming under the jurisdiction of the FDA. Patty Lovera of Food & Water Watch testified: “The USDA is in charge of meat and poultry. The FDA is in charge of basically everything else. We spend a lot of time in this context thinking about the FDA because those are the products that are coming in at this point from China.”¹⁶²

Relative to its broad oversight role, the FDA's capabilities are limited. At the Commission's 2008 hearing on food safety in the seafood industry, the FDA's director of the Center for Food Safety and Applied Nutrition acknowledged that the surge of Chinese food imports has “outstretched and outgrown the regulatory system for imports in the [United States].”¹⁶³ Based on expert testimony received by the Commission in 2008 and 2013, the FDA inspects less than 2 percent of the food that passes through U.S. borders.¹⁶⁴ Inspection rates in Japan and the European Union are several times higher.¹⁶⁵ Nor does the agency always act forcefully when it discovers a problem; shipments are turned away by the FDA but not destroyed, so that products can potentially reenter the country through another port, a phenomenon known as “port-shopping.”¹⁶⁶

According to Ms. Lovera, weak regulation at the border is compounded in China's case by a lack of cooperation between the two countries' authorities. During the melamine-tainted pet food crisis in 2007, for example, it took the FDA one month to identify and communicate with its regulatory counterparts in China.¹⁶⁷ A USDA Economic Research Service report from 2009 asserts that the Chi-

nese government guards the food safety data it collects, making it difficult to impartially evaluate China's food safety performance.¹⁶⁸ Kelli A. Giannattasio, the FDA's deputy country director in China, told the Commission that some progress has been made since then to widen channels of communication. Nonetheless, China's balkanized system of regulation, in which food production and distribution is overseen by different agencies at the central and local levels, has made it difficult to identify the right counterparties once a risk is identified.¹⁶⁹

The FDA has made substantial efforts to improve its border inspections. These were outlined by the FDA's associate director for Global Operations and Policy, Steven M. Solomon, at a May 2013 hearing of the Congressional-Executive Commission on China. Mr. Solomon pointed out that the 2011 Food Safety Modernization Act, the most wide-reaching reform of U.S. food safety laws in 70 years, lays the foundation for a more prevention-based approach to regulating imports. He also noted that, while the FDA does not "physically inspect all imports" that enter the country, it does "electronically screen all imports using an automated risk-based system to determine if shipments meet identified criteria for physical examination or other review." To enhance its ability to target high-risk products, the agency recently developed the Predictive Risk-based Evaluation for Dynamic Import Compliance Targeting application, a screening system that uses intelligence from many sources to provide the entry reviewer with risk scores on every import line.¹⁷⁰

The FDA is also trying to involve U.S. importers more directly in food safety oversight. Under the Foreign Supplier Verification Program, introduced in August, food importers in the United States must assess which types of safety risks are posed by the food they are importing and obtain documentation from the exporter that show how those risks are being mitigated. Importers will be required to conduct or obtain results of annual on-site audits of the exporter's facility. One loophole in the new regulations is that they do not apply to aquaculture products, one of the U.S.'s top imports from China. Aquaculture products are subject only to the less stringent Hazard Analysis and Critical Control Points program, under which importers are not required to retain detailed documentation to show how their foreign suppliers are controlling risks.¹⁷¹

To supplement the efforts to improve food regulation at home, U.S. food safety inspectors have attempted to step up their on-the-ground presence in China. According to Ms. Lovera, the FDA visited just 46 food firms on the Mainland in 2001–2008—less than six a year.¹⁷² Since then, the agency has devoted more resources to its food safety oversight in China. Initial budget increases were enacted in 2009. The fiscal year 2013 Continuing Resolution added \$10 million to the FDA's base to fund the addition of seven food and nine drug inspectors permanently posted in China.¹⁷³ Under a memorandum of agreement that the U.S. Department of Health and Human Services signed with China in December 2007, the Chinese government permitted more FDA inspectors to enter the country and allowed the FDA to open offices in Beijing, Shanghai, and Guangzhou.¹⁷⁴ Commission witness William Westman, who served as agricultural attaché to the U.S. embassy in Beijing in the mid-2000s, noted that 11 FDA attachés were installed at the various

U.S. consulates by the end of his tenure.¹⁷⁵ According to the FDA's fiscal-year 2013 appropriations report, its inspections in China increased from 16 in 2009 to 55 in 2011, a tangible improvement.¹⁷⁶

Still, U.S. food safety regulation in China has many shortcomings. Even with additional inspectors on the Mainland, the agency may find it difficult to monitor China's vast and fragmented food processing industry.¹⁷⁷ Regulatory barriers imposed by Chinese authorities have added to the problem. Stated Ms. Giannatasio:

*Currently, our main challenge stems from delays in issuance of visas for additional FDA staff in China. . . . To date, China's Ministry of Foreign Affairs has not issued diplomatic visas that would enable the deployment of these inspectors to China on a full-time basis. In order to continue its inspection efforts, FDA's China Office is working with FDA's Office of Regulatory Affairs to deploy inspectors on temporary assignment to carry out the inspections FDA needs to do in China.*¹⁷⁸

Another impediment is China's reluctance to grant access to plants. Under the memorandum of agreement signed with the United States in 2007, the Chinese government promises FDA inspectors better access to Chinese facilities but reserves the right to control their movements and access.¹⁷⁹ These restrictions appear to still be in place—during August 2012 visits to Chinese processing plants that export pet treats to the United States, U.S. inspectors were not permitted to collect samples for independent analysis.¹⁸⁰

The United States and China are working together to improve food safety. Examples of collaboration include:

- The USDA and the FDA, along with major U.S. companies, participate in the China State Council's annual China International Food Safety and Quality Conference and Expo, inaugurated in 2007.¹⁸¹
- A working group on economically motivated adulteration meets on a regular basis by video, linking Washington-based experts with the China Food and Drug Administration's key decision-makers.¹⁸²
- In November 2012 and May 2013, the FDA and China's General Administration of Quality Supervision, Inspection and Quarantine held workshops for members of Chinese industry to address concerns regarding aquaculture practices for fish farms. These workshops have significantly enhanced the FDA's understanding of China's oversight system for aquaculture products and have provided Chinese industry with a clearer understanding of the FDA's requirements and practices.¹⁸³
- The China-U.S. Plan of Strategic Cooperation in Agriculture (2012–2017), signed in February 2012 by the USDA and China's Ministry of Agriculture, states that the two countries will develop “mutually beneficial international standards on food safety”; ensure implementation of science-based laws, regulations, policies, and standards; ensure transparency of the regulatory decision-making process and food safety initiatives; and

improve institutions and working mechanisms of emergency response. To this end, both sides “propose to more actively engage” in bilateral and international meetings.¹⁸⁴

Implications for the United States

China is now the top market for U.S. agricultural exports, but not everyone in the U.S. farming community is benefitting equally. China’s imports from the United States have been concentrated in bulk commodities, a trade pattern quite different from U.S. agricultural exports to the rest of the world. U.S. soybean exporters have gained disproportionately, to the extent that they have become quite dependent on the Chinese market. A problem for all bulk commodity exporters to China is that nation’s policy of using taxes and subsidies, in combination with stockpiling and state trading, to control commodity trade flows. Therefore, much of the value-added processing of commodities is taking place in China rather than in the United States, which is hurting U.S. manufacturers and contributing to U.S. unemployment.

Among consumer foods, U.S. meat products have the most to gain in China. Chinese consumers are shifting to a higher-priced, protein-heavy diet, while China’s domestic livestock industry is reaching its capacity limits. The United States enjoys a comparative advantage in resources, productivity, and quality for meat production. And yet, U.S. beef and pork producers have been affected by China’s heavy subsidization of domestic production and, even more, by its stringent sanitary barriers. Many sanitary measures appear designed either to protect domestic producers or to shift the blame for domestic food safety lapses onto foreign products. A complicating factor for the United States is that China is not alone in abusing health and safety measures. Some of the U.S.’s best beef export markets have been slow to lift BSE-related restrictions. Japan, South Korea, and Taiwan will only accept U.S. beef from animals less than 30 months of age.¹⁸⁵ The European Union and Taiwan ban imports of U.S. pork treated with ractopamine.¹⁸⁶ By the same token, the intensifying competition from other agricultural exporters, such as Australia, Brazil, and Argentina, allows China to hedge its import strategy in ways that can damage U.S. interests.¹⁸⁷

A key challenge for the United States is to treat China as a major market rather than a developing country in need of development assistance. The United States and China are engaging in extensive bilateral cooperation in agriculture. The USDA has signed a Plan of Strategic Cooperation with its Chinese counterparts on agricultural science, trade, and education. U.S. universities and companies are also actively engaged in China. But this outreach is not always conducive to improving market access for U.S. exporters and foreign investors, who view China as a strategic market for their business.

Another challenge is to reconcile different interests in U.S. trade policy. In regional terms, Iowa has profited the most from trade with China, given its extensive production of crops to feed China’s livestock. The Iowa state government has been very proactive in fostering bilateral diplomacy. Conversely, specialty crop growers in

the Pacific Northwest, beef producers in the Central Plains, and cotton and poultry producers in the South have been more critical of the evolving relationship. There is also a need to recognize the actors in China that might be for and against trade with the United States. For example, the Ministry of Agriculture, which prioritizes the interests of Chinese farmers, and the Ministry of Commerce, which seeks to implement China's WTO commitments, do not always share common interests.

The case of poultry illustrates the tradeoffs of negotiating bilateral trade deals. U.S. poultry producers have been the unfortunate targets of Chinese retaliation in a broader trade dispute involving auto parts and tires. U.S. government efforts to support domestic producers and protect consumers in the food sector have not always achieved to their intended effects and, in some cases, have worked at cross purposes. Food safety advocates argue that allowing China to export processed poultry to the United States is too high a price to pay for greasing the wheels of bilateral trade deals.

WTO accession has allowed China to export vast amounts of fruits, vegetables, fish, and processed foods to the United States, causing health scares and overstressing the U.S. food inspection regime. In the future, the U.S. government will have to strike a balance between expanding a rules-based trading regime that favors exporters and taking action to block Chinese imports if safety cannot be assured. It will also need to enhance the capacities of the USDA and the FDA to screen food imports at the border and on the ground in China. That will require better cooperation from the Chinese authorities—the U.S. State Department last October formally notified the Chinese Ministry of Foreign Affairs about obtaining visas for additional FDA inspectors, but as of September 2013, the visas had not been granted.¹⁸⁸

The proposed acquisition of Smithfield by a Chinese pork producer, Shuanghui, was approved by CFIUS and by Smithfield's shareholders in September. The case illustrates that Chinese companies can make major acquisitions of U.S. companies in the agriculture sector without being blocked on national security grounds. At the same time, the case elicits important questions about U.S. policy toward foreign investors from China. Smithfield is the largest pork producer in the United States and hence a strategic supplier of food to U.S. consumers. While Shuanghui is a quasi-private company, it maintains strategic ties to the Chinese government. The case also has a bearing on intellectual property protection, net economic benefits, and reciprocal market access.

Conclusions

- For the past three years, China has been the largest export market for U.S. agricultural goods. However, trade is far from free, and enormous opportunities are being withheld. China's WTO accession has not been as productive to the United States as initially expected. In contrast to U.S. agricultural exports to the rest of the world, most U.S. exports to China are bulk commodities, particularly raw soybeans that supply China's outsized livestock sector. Conversely, processed commodities, meat products,

consumer foods, and other higher value-added products have not kept pace with the overall growth in bilateral trade.

- Since the 1980s, China has developed into the world's largest agricultural economy, producing a fifth of the world's grains, a quarter of its meat, and half of its vegetables. But demand in China is beginning to outstrip supply. As more people move to cities and earn higher incomes, China's population is demanding safer food and a more diverse, protein-rich diet at an affordable cost. The United States is well-positioned to meet that demand. U.S. farmers enjoy a comparative advantage in resources, productivity, and quality, particularly in meat production.
- China's agriculture policy favors domestic production over imports. China maintains ambitious self-sufficiency targets that are unsustainable and unjustifiable in terms of food security. This policy is now being challenged by the decline in China's farm labor surplus, deteriorating land and resource endowments, and fragmented producer and land use systems. A related problem is that efforts to modernize agriculture conflict with rural welfare aims. Millions of rural migrants continue to rely on farmland and smallholder agriculture for insurance in the absence of a functioning welfare state.
- China has failed to fully perform its obligations under the WTO. It has erected a series of nontariff barriers that include state trading; excessive domestic subsidies and stockpiling of commodities; discriminatory taxes; uncalled-for antidumping duties; and slow approvals of biotechnology applications for U.S. crops. Damaging to U.S. interests as well are sanitary and phytosanitary restrictions, especially BSE-based bans on beef and zero tolerance for ractopamine in pork. Although China has significantly lowered its tariffs and increased its agricultural imports since accession, numerous trade restrictions remain in place.
- U.S. companies, universities, and government agencies are helping China to improve the quantity and quality of its food output. In a sign of deepening bilateral ties, the United States and China signed the first U.S.-China Plan of Strategic Cooperation in Agriculture (2012–2017) in February 2012, and in March of that year the largest-ever U.S. agricultural trade mission visited China. However, U.S. companies operating in China are hamstrung by regulatory uncertainty, restricted market access, and weak intellectual property enforcement.
- China is fostering globally competitive agribusinesses, in the process becoming an active acquirer of agricultural assets overseas. In June 2013, China's largest pork producer, Shuanghui, proposed a \$7.1 billion acquisition of Smithfield, the leading pork producer in the United States. While the deal has been approved by CFIUS and Smithfield's shareholders, it raises critical issues regarding net economic benefits, intellectual property, reciprocal market access, and the treatment of quasi-private Chinese companies that maintain links to the Chinese government.
- China accounts for a large share of the fruits, vegetables, fish, and processed foods that Americans consume, but the United States has little assurance that the food imports coming into the

United States from China are safe. China's own food safety regulation is still ineffective, in spite of recent efforts to consolidate agencies and improve legislation. U.S. consumers rely on U.S. food safety inspectors to do their jobs, but U.S. regulation is also fragmented and underfunded. U.S. regulators have increased their presence within China but have struggled to obtain work visas and to gain access to food production facilities. Although the United States does not permit raw meat imports from China, the USDA has granted equivalence status to Chinese poultry processors, which will permit them to process poultry raised in the United States and Canada and ship it to the United States.

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RECOMMENDATIONS

Trends in Chinese Investment in the United States

The Commission recommends:

- Congress assess the extent to which existing laws provide for inadequate or ineffective remedies against the anticompetitive actions of Chinese state-owned or state-invested enterprises operating in the U.S. market. Additional remedies may be required to account for the fact that these enterprises may not be operating based on commercial considerations.
- Congress assess whether to amend the Committee on Foreign Investment in the United States (CFIUS) statute to allow review of greenfield investments for threats to U.S. national security.
- Congress direct the Department of Commerce to develop a comprehensive ongoing inventory of Chinese foreign direct investment (FDI) in the United States and, on an annual basis, update the inventory. The inventory should identify the ownership structure of the entity engaging in the investment. In preparing the inventory, the department should call on private sector entities engaged in monitoring Chinese investments in the United States and such other entities to ensure that its report is complete and accurate. The department should prepare a comprehensive report to Congress on an annual basis identifying the FDI by Chinese entities that were made in the previous calendar year. In its report, the department should indicate those investments that received any assistance from the “Select USA” program. The department should also identify, on an ongoing basis, the lines of commerce that each of the investments are engaged in.

Governance and Accountability in China’s Financial System

The Commission recommends:

- Congress direct the Administration to press China for more cooperation with the international community in order to address the global economic risks of unregulated and underregulated shadow banking and ask the Department of the Treasury to provide an annual report to Congress on the risks of shadow banking
- Congress direct the Administration, in any bilateral investment treaty negotiations, to make fair and equitable market access and treatment for financial services firms a priority.
- Congress direct the Administration to assist the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board by encouraging China to develop better reg-

ulatory oversight enforcement capabilities and more transparent markets, during annual and biannual bilateral dialogues, as well as multilateral dialogues.

- Congress empower the SEC to set minimum standards for companies listing and maintaining listings on U.S. exchanges and enable the SEC to directly delist foreign companies not in compliance with these standards.

China's Agriculture Policy, Food Regulation, and the U.S.-China Agriculture Trade

The Commission recommends:

- Congress monitor the implementation of the U.S.-China Plan of Strategic Cooperation in Agriculture (2012–2017) to ensure that U.S. funding is being allocated in such a way as to improve the safety, sustainability, efficiency, and security of food production in China and the United States.
- Congress require the U.S. Department of Agriculture (USDA) and the U.S. Trade Representative (USTR) to conduct a comprehensive review of China's agricultural subsidies, discriminatory taxes, state trading, and procurement practices; take account of the damages incurred by U.S. farmers and downstream industries; and suggest appropriate remedies.
- Congress urge the Secretary of Agriculture to engage, as part of the Joint Committee on Commerce and Trade and the Strategic and Economic Dialogue, with his/her Chinese counterparts to address those Chinese policies and practices that limit U.S. exports of value-added products.
- Congress direct the Interagency Trade Enforcement Center (ITEC) to conduct a review of the selective use of value added tax (VAT) rebates by China and determine whether they have a trade-distorting effect and whether the selective use of VAT rebates is consistent with the original intent of the General Agreement on Tariffs and Trade (GATT) provision allowing for VAT rebates. The ITEC should prepare a report for the U.S. Trade Representative and the relevant Committees of jurisdiction and identify what steps should be taken to address any GATT inconsistencies, should they be found.
- Congress direct the USDA to negotiate with China to synchronize approvals of biotechnology to ensure stable and predictable market access for U.S. seed companies and crop growers in the Chinese market.
- Congress require that the USDA prepare an annual report on competitive factors in the pork industry. In preparing such reports, the department shall evaluate the impact, if any, of the recent purchase of Smithfield Foods on the ability of other U.S. producers to export pork products to China. In addition, the report shall identify any changing pricing structures throughout the pork production chain to determine whether there is price or profit suppression as a result of the Smithfield transaction.

- Congress direct the USDA to exercise extreme caution in negotiating equivalency status for Chinese exports of processed poultry using Chinese-origin birds. Congress should also increase its support of USDA's Food Safety and Inspection Service in its role as protector of meat and poultry food safety so that the United States serves as a world model for high-quality, science-based regulations.
- Congress ensure that the Food and Drug Administration makes it a priority to increase the number of physical inspections of Chinese food imports at the border; to increase the rigor of those inspections to include testing for pathogens and chemical, pesticide, and drug residues, and processed food ingredients; and to conduct more frequent and thorough inspections in food facilities in China. Congress should also urge the USDA to permanently assign inspection personnel to China so that the exporting plants receive regular visits by USDA inspectors.
- Congress require the Secretary of Agriculture to prepare a report to Congress identifying those organic food products being imported into the United States from China. The report should include a comprehensive evaluation of the different methodologies employed by the United States and China to certify that a product is organic and what steps, if any, are being taken to harmonize any discrepancies that might exist.
- Congress evaluate whether a requirement that U.S. food importers purchase insurance against food-borne illnesses and pathogens from Chinese imports would improve food safety. Such a program would involve private sector risk insurance with insurance companies evaluating the safety of various sources and charging risk-based premiums based on the methods employed by Chinese exporters to address food-borne illnesses and pathogens.