

## CHAPTER 1

### U.S.-CHINA ECONOMIC AND TRADE RELATIONS

#### SECTION 1: YEAR IN REVIEW: ECONOMICS AND TRADE

##### Introduction

China is navigating a complex economic transformation as it experiences a slower pace of growth. The Chinese leadership proclaimed during the 2013 Third Plenary Session of the 18th Chinese Communist Party (CCP) Central Committee (hereafter, “Third Plenum”) that it is working toward a more market-based economic system. However, Party documents and official actions indicate the Chinese government’s approach to reform is different from the liberal market reform Western observers expect. By “reform,” China’s leaders mean an economy that more efficiently achieves the strategic goals of the state. While reform in the Chinese sense allows for incremental movements toward a free market in certain areas, it precludes any changes that substantially reduce the government’s power over the economy.

Beijing’s state-directed approach raises questions about the sustainability of China’s economic growth. Government stimulus has largely accrued to the state sector while the private sector struggles to secure credit, endangering China’s rebalancing. Within China’s economic downturn, a tale of two Chinas is emerging. In one, traditional drivers of growth—heavy industry and low-end manufacturing—are in decline, while in another, newer sectors—services, consumer goods, and technology—are burgeoning. Still, the old economy remains critical for some provinces, and the new economy—so vital to China’s future growth—is nascent, underfunded, and not pulling its weight. National-level economic data also belie sharp discrepancies between the northeastern and western provinces dependent on the old economy and the southern and eastern regions with more diversified economies.<sup>1</sup> Externally, China’s rebalancing has proceeded slowly as the country continues to run massive global trade surpluses: in 2015, China’s global trade surplus in goods and services reached \$595 billion, up from \$382 billion in 2014.<sup>2</sup>

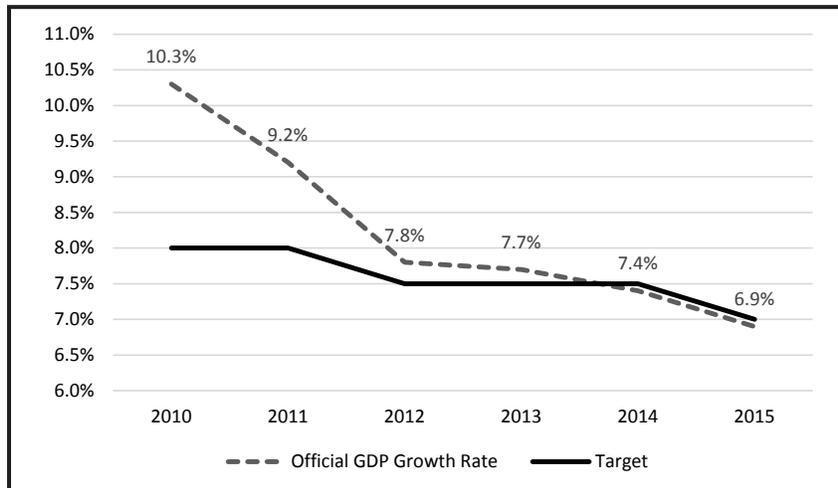
This section examines China’s domestic and external rebalancing as well as key developments in U.S.-China bilateral and multilateral engagement since the Commission’s *2015 Annual Report to Congress*. For analysis of some of the key challenges China faces as it seeks to rebalance its economy, see Chapter 1, Section 2, “State-Owned Enterprises, Overcapacity, and China’s Market Economy

Status.” For an in-depth examination of China’s reform agenda, see Chapter 1, Section 3, “13th Five-Year Plan.”

### China’s Domestic Rebalancing

In 2015, China’s officially reported gross domestic product (GDP) growth fell to 6.9 percent—a 25-year low—in line with the official GDP target of “around 7 percent” (see Figure 1).<sup>3</sup> The Chinese government announced a 6.5 percent to 7 percent growth target for 2016.<sup>4</sup> The range acknowledges China’s “new normal” of slower growth and gives it more flexibility to meet its target. In the second quarter of 2016, China’s economy grew 6.7 percent, the same rate as in the previous quarter, its weakest pace of expansion since 2009.<sup>5</sup> Key economic indicators show the government’s hand in stabilizing the economy through large-scale stimulus. Industrial production and retail sales rose, buoyed by government stimulus measures, while fixed asset investment (FAI)\* weakened.

**Figure 1: China’s GDP Growth, 2010–2015**  
(year-on-year)



Source: Various.<sup>6</sup>

### Statistics with Chinese Characteristics: The Reliability of China’s GDP Data

In the first half of 2016, the Chinese government reported GDP growth of 6.7 percent, but many foreign economists believe official statistics overstate the economy’s performance. There has been longstanding skepticism among economists, investors, and analysts about the reliability of Chinese official economic data, par-

\* FAI is a measure of capital spending referring to any investment by government and businesses in physical assets, such as buildings, machinery, and equipment.

**Statistics with Chinese Characteristics: The Reliability of China's GDP Data—Continued**

ticularly the politically sensitive GDP growth rate.\* They point to inconsistencies with official statistics—discrepancies between GDP data published at the national and provincial levels and the headline GDP and sectoral data—which raise the likelihood of inaccurate statistics.<sup>7</sup> Moreover, China's quarterly and annual GDP data are unusually smooth compared to other major economies, evincing “little or no volatility compared to growth targets.”<sup>8</sup>

Most unofficial estimates of China's growth in the first half of 2016 fall below the reported 6.7 percent.<sup>9</sup> For example, economic research consultancy Capital Economics estimates China's GDP grew at 4.5 percent in the second quarter of 2016.<sup>10</sup> Preliminary estimates from Lombard Street Research, another research consultancy, assess China's GDP growth at 6 percent in the second quarter of 2016.<sup>11</sup> However, estimates struggle to accurately capture the rising role of services in China's economy due to the dearth of available data.<sup>12</sup> The International Monetary Fund's (IMF) annual review of China's economic and financial policies finds that while “there is some evidence pointing to possible overstatement of growth recently ... the overstatement is likely moderate and the official national accounts data—while there is much room for improvement—likely provides a broadly reliable picture.”<sup>13</sup>

Top officials, including Premier Li Keqiang and Ning Jizhe, the new head of China's National Bureau of Statistics,† have pushed for better data on the country's “new economy” industries.‡ Official data focus on measuring industrial activity and fail to reflect newer economic drivers, such as online retail sales, because they do not fit neatly into existing categories.<sup>14</sup> China's National Bureau of Statistics is expected to issue guidelines for compiling data across new economy sectors by the end of 2016.<sup>15</sup>

In the second quarter of 2016, FAI grew 9 percent from the second quarter of 2015 (year-on-year), its slowest pace since 2000.<sup>16</sup> Conditions in China's industrial sector were weaker than in the first quarter. Unofficial estimates by Caixin, a Chinese financial media group, showed China's manufacturing Purchasing Managers' Index (PMI)§

\*For an in-depth examination of the reliability of China's economic statistics, see Jacob Koch-Weser, “The Reliability of China's National Economic Data: An Analysis of National Output,” *U.S.-China Economic and Security Review Commission*, January 28, 2013.

†Ning Jizhe's predecessor was ousted in January 2016 over unspecified corruption allegations after less than a year on the job. Gabriel Wildau, “China's Statistics Chief Wang Baoan Accused of Corruption,” *Financial Times*, January 26, 2016.

‡In a press conference after the conclusion of the National People's Congress in March 2016, Premier Li said, “The concept of the new economy covers a wide range of areas and has many dimensions.... It's not just about emerging forms of business and industries such as e-commerce, cloud computing, the Internet of things and Internet. It can also be found in smart manufacturing, large-scale customer-made production in the industrial sector.” State Council of the People's Republic of China, *Premier Li Keqiang Meets the Press: Full Transcript of Questions and Answers*, March 16, 2016.

§The PMI measures the level of economic activity in the manufacturing sector based on five sub-indicators: production level, new orders, inventories, supplier deliveries, and employment level. The Caixin-Markit China manufacturing PMI is compiled by Markit Economics, a global financial information services provider, based on monthly responses to questionnaires sent to purchasing executives from over 420 manufacturing firms, including small and medium-sized enterprises. The China Mixin PMI, a less high-profile private gauge of manufacturing activity,

Continued

at 48.6 in June 2016, down from 49.2 in May, the third consecutive monthly decline (a reading below 50 points indicates contraction of the manufacturing sector).<sup>17</sup> Value-added industrial growth—viewed by markets as a proxy for economic growth—expanded 6.2 percent year-on-year in June.<sup>18</sup> The recovery in the property market during the first half of 2016 helped to cushion the slowdown in the broader economy; housing sales rose 44.4 percent year-on-year in the first half of 2016.<sup>19</sup> However, slowing property investment growth in the first half of 2016 indicates the stimulus-driven recovery in the property sector is tapering off.\*

Consumption's contribution to GDP in 2016 continued to increase, accounting for 73.4 percent of growth in the first half of 2016, compared to 60 percent of growth in the first half of 2015.<sup>20</sup> Retail sales of domestic goods and services, a proxy measure for overall consumption, grew at a better-than-expected 10.6 percent year-on-year in June 2016, the highest reading since December 2015.<sup>21</sup> However, because China's retail sales figures include private and government purchases, disposable personal income† can be a more accurate indicator of household spending.<sup>22</sup> In the first half of 2016, China's national per capita disposable income, adjusted for inflation, grew 6.5 percent year-on-year to \$1,774 (renminbi [RMB] 11,886).‡<sup>23</sup> (For comparison, the U.S. national per capita disposable income was \$43,095 in the second quarter of 2016.)<sup>24</sup> Despite strong retail sales data, growth in consumer spending is likely to weaken, as income gains slow§ and household savings rates remain high—the average Chinese household saves as much as 40 percent of its income.¶<sup>25</sup>

Beijing is relying on a stronger service sector to help offset the contraction in its manufacturing sector and to provide jobs for laid-off factory workers.<sup>26</sup> In 2015, services grew 8.3 percent, generating for the first time more than half of China's GDP (50.5 percent).<sup>27</sup> The sector expanded at a slightly slower pace in 2016—in the second quarter, it grew 7.5 percent, surpassing a 6.3 percent increase in the secondary industry, and accounted for 54.1 percent of GDP,

was suspended "indefinitely" in July 2016 by its publishers, the China Minsheng Bank and the government-affiliated China Academy of New Supply-Side Economics. China's official PMI, compiled by the National Bureau of Statistics, tracks larger state-owned companies and generally shows a stronger reading than the private PMIs. *Financial Times*, "Independent Chinese PMI Gauge Suspended Indefinitely," July 20, 2016; Caixin Purchasing Managers' Index, "Caixin China General Manufacturing PMI," July 1, 2016.

\*The decline in property investment growth is due in part to weak property developer sentiment and housing inventory oversupply. Property investment from January to June 2016 rose 6.1 percent year-on-year, slowing from an increase of 7 percent from January to May 2016. Property investment for June 2016 increased a mere 3.5 percent from a year ago, compared with 6.6 percent in May. Clare Jim, "China Property Investment Growth Slows, Recovery Seen at an End," Reuters, July 15, 2016; Elias Glenn and Kevin Yao, "Government Spending Steadies China's Economy in Second-Quarter but Risks Grow," Reuters, July 15, 2016; and *Financial Times*, "Real Estate to Remain a Growth Lifeline for China through 2016," July 10, 2016.

†Disposable personal income is the amount of income households have for spending and saving after income tax.

‡Unless otherwise specified, this Report uses the following exchange rate throughout: 1 U.S. dollar = 6.70 RMB.

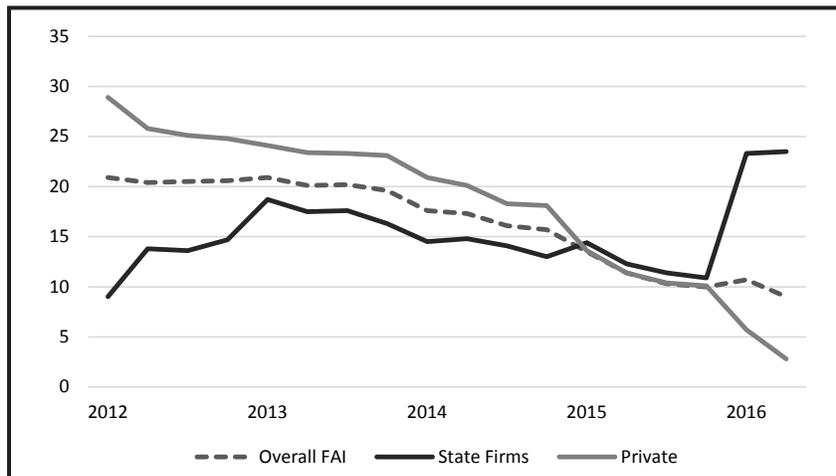
§In July 2016, Xin Changxing, vice minister of China's Ministry of Human Resources and Social Security, called for a slowdown in wage increases to maintain competitiveness. Several provinces have slowed or halted increases to minimum wages this year, as Chinese companies face increasing pressure from weakening demand and rising expenses. Nick Heath and Winni Zhou, "China Will Struggle to Maintain Growth Pace for Wages: Statistics Bureau," Reuters, July 16, 2016.

¶In comparison, the U.S. household savings rate is 5.2 percent. Chinese officials, meeting with Commission, Beijing, China, June 24, 2016; China's National Bureau of Statistics, *China Had a Good Start in the First Quarter of 2016*, April 15, 2016; and Alexandra Stevenson, "As Growth Slows, China Pins Hopes on Consumer Spending," *New York Times*, January 19, 2015.

up from 52.3 percent in the second quarter of 2015.<sup>28</sup> The fastest growth has come from “other” services, a broad category that includes business services, education, entertainment, and healthcare.\* While financial services was the main contributor to overall service growth in the first half of 2015, its share has been in decline since the stock bubble burst last June.<sup>29</sup>

Although China’s state-owned economy has declined in relative importance, it remains significant, accounting for 16 percent of GDP and more than half of corporate debt.<sup>30</sup> The Xi Administration has identified state-owned enterprise (SOE) reform as an essential step to restructuring the economy.<sup>31</sup> Concentrated in heavy industry and construction, and burdened by overcapacity and debt, the state sector is tied to the old growth model from which Beijing says it has been trying to move away. China’s political reality, however, shows that the government continues to support SOEs. Even as Beijing states its intent to promote a productive private sector, it largely channels credit to the inefficient state sector.<sup>32</sup> (In 2015, industrial SOEs had a return on assets of 2.9 percent, compared with 10.3 percent for private industrial enterprises.)<sup>†33</sup> During the second quarter of 2016, state sector investment expanded 23 percent year-on-year, while private investment growth slowed to a record low of 2.8 percent (see Figure 2).<sup>34</sup> Meanwhile, SOE profits fell 6.7 percent year-on-year in 2015 and 8.5 percent year-on-year in the first half of 2016, despite the government’s efforts to boost economic growth.<sup>35</sup> (For more on China’s efforts to restructure its SOEs, see Chapter 1, Section 2, “State-Owned Enterprises, Overcapacity, and China’s Market Economy Status.”)

**Figure 2: China’s Fixed Asset Investment**  
(% change year-on-year, year-to-date)



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

\*A lack of detail on “other” services makes it difficult to assess which service industries within that category are driving growth. Gabriel Wildau, “China Services Sector Key to Growth,” *Financial Times*, December 6, 2015.

†For comparison, the average 2015 year-end return on assets of the top 20 U.S. companies listed on the Fortune 500 was 4.9 percent. Return on assets data were compiled from YCharts, a financial data and analytics provider. YCharts. <https://ycharts.com/companies>.

### **Key Government Statements on Economic Reform**

Third Plenum Decision (November 2013):<sup>36</sup>

*We must deepen economic system reform by centering on the decisive role of the market in allocating resources, adhere to and improve the basic economic system, accelerate the improvement of the modern market system, macro-control system and open economic system.*

*The basic economic system with public ownership playing a dominant role and different economic sectors developing side by side is an important pillar of the socialist system with Chinese characteristics and is the foundation of the socialist market economy. Both the public and nonpublic sectors are key components of the socialist market economy, and are important bases for the economic and social development of China. We must unswervingly consolidate and develop the public economy, persist in the dominant position of public ownership, give full play to the leading role of the state-owned sector, and continuously increase its vitality, controlling force and influence. We must unwaveringly encourage, support and guide the development of the nonpublic sector, and stimulate its dynamism and creativity.*

Guiding Opinion on Deepening the Reform of State-Owned Enterprises (September 2015):<sup>37</sup>

*The fundamental requirement for deepening SOE reform is to uphold and improve the basic economic system. We must unswervingly consolidate and develop the public economy, and unswervingly encourage, support, and guide the development of the nonpublic economy. We must uphold the dominant position of public ownership and develop the leading role of the state-owned economy.*

### **China's Supply-Side Structural Reforms**

Chinese President and General Secretary of the CCP Xi Jinping has made “supply-side structural reform” the dominant theme of economic policy in 2016, after announcing it during the Central Economic Work Conference last December.<sup>38</sup> In the Chinese context, supply-side reform has become an umbrella term for structural reforms: the main thrust of the reforms, according to President Xi, is “to reduce ineffective supply, increase effective supply, and make the supply structure more fitting to the demand structure.”<sup>39</sup> President Xi differentiates China’s version of “supply-side structural reform” from Western supply-side economics: the end goal of Chinese reform, according to President Xi, is not “small government, big market,” but “effective government and effective markets.”<sup>40</sup> Key elements of the policy include cutting excess industrial capacity and housing inventories, deleveraging, and reducing business costs.<sup>41</sup> The central government has put the onus on local governments to work out how to operationalize and implement these broad policy planks.<sup>42</sup>

Early signs suggest President Xi's supply-side focus has not yet translated into a serious change of course. Facing a sharp slowdown in growth and large capital outflows at the beginning of 2016, Chinese economic policymakers turned to stimulus measures to revive growth.<sup>43</sup> Moreover, capacity reduction efforts in the coal and steel sectors have fallen far short of stated goals.<sup>44</sup> In response, President Xi has sought to rally local officials around the government's agenda.<sup>45</sup> In a May 2016 meeting with senior Party leaders, he expressed his frustration with the lack of progress on supply-side reforms, noting that, "some local governments haven't started vigorous implementation yet, and some efforts are missing the point."<sup>46</sup> In the same month, the *People's Daily* published a transcript of an internal speech President Xi delivered to principal ministerial and provincial officials in January 2016, in which he emphasized the need to "prevent some people from using their interpretations to promote 'neoliberalism.'"<sup>\*47</sup>

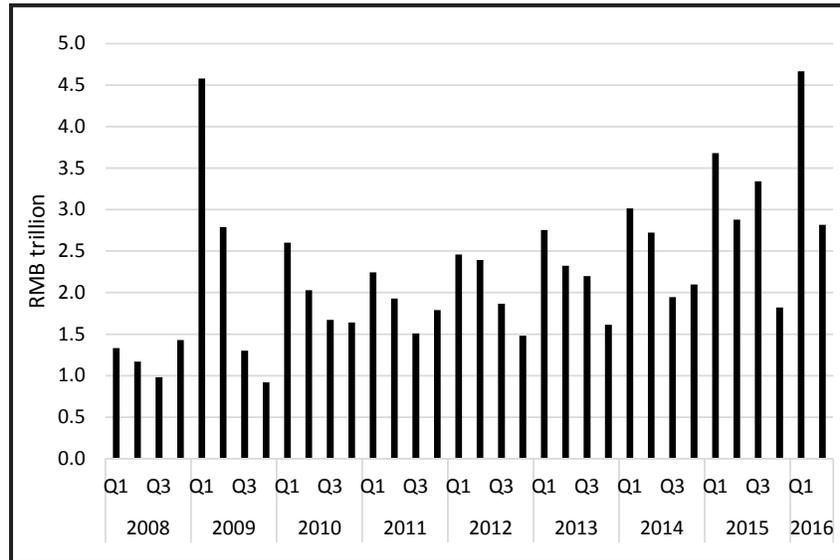
### ***More Stimulus amid Rising Debt***

Escalating lending belies the Xi Administration's promises of supply-side reforms. The Chinese government has ramped up efforts to inject money into the economy and boost economic performance. In February 2016, the People's Bank of China (PBOC) lowered the reserve requirement ratio—or the amount of customers' deposits banks must hold in reserve—by 0.5 percentage points, injecting an estimated \$100 billion in the economy.<sup>48</sup> Furthermore, in the first quarter of 2016, China's state-controlled banks released a record \$701 billion (RMB 4.7 trillion) of credit, slightly surpassing the \$687 billion (RMB 4.6 trillion) released in the first quarter of 2009 during the global financial crisis.<sup>49</sup> The 2009 stimulus helped China rebound from the global slump, but it also greatly worsened the country's industrial overcapacity and debt levels.<sup>50</sup> While lending eased overall to \$432.8 billion (RMB 2.9 trillion) in the second quarter of 2016, the pace of lending picked up again in June, with new loans totaling \$209 billion (RMB 1.4 trillion) (see Figure 3).<sup>51</sup>

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\*Neoliberalism is an economic philosophy that emphasizes transferring control of economic factors from the public sector to the private sector. Key tenets include deregulation, privatization, free trade, fiscal austerity, and reduced government spending.

**Figure 3: New Loans Issued by Chinese Banks, 2008–2016 Q2**  
(year-on-year)



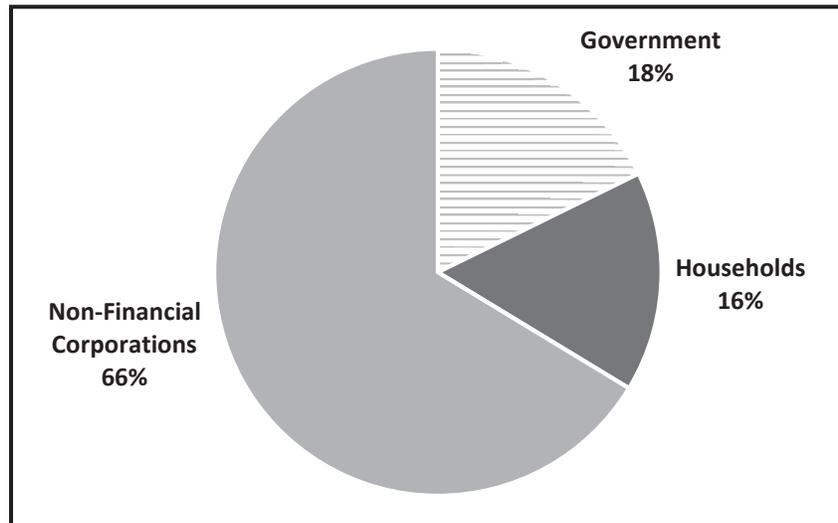
Source: The People's Bank of China via CEIC database.

China's continued reliance on borrowing from its state-controlled banks to bolster growth raises concerns about the sustainability of gains made in the first half of 2016. China's stimulus policies are delivering rapidly diminishing returns. According to Morgan Stanley, it now takes nearly six RMB of additional credit to generate one RMB of GDP growth.<sup>52</sup> From 2003 to 2008, it took one RMB of extra credit to generate one RMB of growth; this ratio rose to two to one between 2009 and 2010, and reached four to one in 2015.<sup>53</sup>

China's total debt reached a record \$27.2 trillion, or 255 percent of GDP, in the first quarter of 2016, according to data from the Bank for International Settlements (see Figure 4).<sup>54</sup> While China's overall level of debt is a concern, more alarming is the speed at which it has amassed—the country's total debt was only 148 percent of GDP in 2007.<sup>55</sup> In particular, the rapid growth in China's corporate debt—which stands at 169 percent of GDP—is worrying.<sup>56</sup>

\*China's total debt as a proportion of national income is comparable to that of the United States (251 percent of GDP at the end of 2015), but is much higher than in other developing economies. For instance, at the end of 2015, India's total debt was 129 percent of GDP, while Brazil's was 149 percent of GDP. Bank for International Settlements, "Total Credit to the Non-Financial Sector (Core Debt)," May 27, 2016.

Figure 4: China's Total Debt by Holder, 2016 Q1



Source: Bank for International Settlements.

China's high and still rising corporate debt levels present elevated risks to economic growth and financial stability.<sup>57</sup> Rising corporate indebtedness, driven by firms in the real estate and construction sector and SOEs in general, has led to a drop in profitability and return on assets, indicating deteriorating debt-servicing capacity.<sup>58</sup> As Chinese banks make about a half of their loans to companies, an uptick in corporate defaults could have broader implications for the banking sector, such as a worsening of banks' asset quality.<sup>59</sup>

SOEs hold more than half of corporate debt, despite generating only one-fifth of China's total economic output.<sup>60</sup> In addition, state-owned banks are SOEs' biggest creditors, enabling the government to issue nonproductive loans and forgive SOE debts—a classic example of moral hazard.<sup>\*61</sup> (For more on the challenges associated with SOE debt, see Chapter 1, Section 2, "State-Owned Enterprises, Overcapacity, and China's Market Economy Status.") At the same time, nonperforming loans (NPLs)—loans that are unlikely to be paid back—are piling up. According to the China Banking Regulatory Commission, Chinese banks' NPLs amounted to 2.15 percent of total loans at the end of May 2016, up from 1.75 percent at the end of March.<sup>62</sup> However, the actual NPL ratio may be much higher; brokerage firm CLSA estimates that NPLs accounted for 15 percent to 19 percent of loans in 2015, compared with the official 1.67 percent.<sup>†</sup>

\*Moral hazard occurs when one party takes greater risks than it would otherwise because another party bears the cost of the risks.

†The sizable discrepancy between the official NPL ratio and unofficial estimates comes from how banks categorize NPLs. The IMF considers a loan nonperforming if interest and principal payments are more than 90 days overdue. In China, a loan more than 90 days overdue is considered nonperforming only if loans are doubtful or loss making. As SOE borrowers are presumed to have government backing, it can be difficult for banks to characterize their loans as nonperforming. There is also a separate category—"special mention" loans—for loans that are at risk of becoming nonperforming. CLSA derived its bad debt ratio estimate from Chinese companies' financial statements; a company's

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A 2016 IMF report estimated the potential losses for China's banks from bad corporate loans at 7 percent of GDP.<sup>63</sup>

The rapid growth of China's shadow banking\* sector is another cause for concern due to the risks it poses to financial stability.<sup>64</sup> According to the IMF's 2016 annual Article IV review of China's economy, shadow credit products grew by almost 50 percent in 2015 to \$6 trillion (RMB 40 trillion), or about 58 percent of China's GDP.<sup>65</sup> About half of these shadow credit products pose an "elevated" risk of default or loss.<sup>66</sup>

### **RMB Reforms**

Amid rising financial sector vulnerabilities, the PBOC has found it difficult to maintain momentum on financial reforms while delivering on its mandate to support economic growth. The central bank stated that it wants a more flexible, market-oriented exchange rate regime, but it also desires RMB stability.<sup>67</sup> In pursuit of a stable RMB, the PBOC has been trying to shift market attention from the RMB's movement against the dollar, announcing in December 2015 it would start tracking the value of the RMB based on a broader basket of currencies.<sup>68</sup> According to Eswar Prasad, professor of trade policy at Cornell University, "This move would make it easier for the [PBOC] to delink the RMB from the dollar."<sup>69</sup> In addition, Dr. Prasad said, "The [PBOC] may be preparing the market for further RMB depreciation relative to the dollar in the short turn—if the dollar were to strengthen further—and focusing attention on a more suitable benchmark for future movements in the currency."<sup>70</sup> Some analysts believe China's move to unpeg its currency from the dollar could allow the PBOC to alternate between setting the RMB against the dollar and the currency basket depending on the strength of the dollar, affording the Chinese government greater flexibility with monetary policy.<sup>71</sup>

Beijing has continued to increase the flexibility of its exchange rate,<sup>†</sup> driven in part by its goal of expanding the international use of the RMB. It achieved an important victory in November 2015 when the IMF executive board voted to include the RMB in the Special Drawing Rights (SDR) basket, to become effective in October 2016 (see following textbox).<sup>72</sup> The PBOC has stated that it sees the inclusion of the RMB as a starting point for deeper financial reforms, which include a greater liberalization of China's capital account.<sup>73</sup> Despite this progress, the PBOC still carefully manages the value of the RMB, intervening in foreign exchange markets to keep the currency's external value stable.<sup>74</sup> From August 2015 to June 2016, the PBOC spent about \$473 billion in foreign exchange

loans are classified as nonperforming if its interest expenses surpass operating income, or if its net debt is greater than five years of operating income. Reuters, "UPDATE 1-China's Non-Performing Loans Hit 11-Year High – Regulator," May 12, 2016; Shuli Ren, "CLSA: 15-19% of China's Bank Loans Are Bad," *Barron's Asia* (Blog), May 6, 2016; and Paul Panckhurst, "CLSA Sees China Bad-Loan Epidemic with \$1 Trillion of Losses," *Bloomberg*, May 6, 2016.

\*Shadow banking is lending—to include wealth management products, credit guarantees, entrusted loans, and peer-to-peer lending—that occurs outside of the formal banking sector. For more information on China's shadow banking sector, see U.S.-China Economic and Security Review Commission, Chapter 1, Section 3, "Governance and Accountability in China's Financial System," in *2013 Annual Report to Congress*, November 2013, 113–152.

†Notably, the PBOC took an important step toward a more market-determined exchange rate in August 2015 when it revised its method for setting the daily reference rate for the RMB in the onshore currency market; the PBOC said it would take into account the previous day's closing exchange rate—which could rise or fall up to 2 percent under the currency's trading band—as well as the exchange rate movements of other major currencies. Nicholas Lardy, "China's Latest Currency Actions Are Market Driven," *China Economic Watch* (Peterson Institute for International Economics blog), August 11, 2015.

reserves to defend the RMB.<sup>75</sup> It also has failed to communicate its foreign exchange policy; twice in the past year, the PBOC's poorly communicated efforts to make the RMB more market driven resulted in significant market turbulence.\*

### **China's RMB Joins the IMF's Special Drawing Rights Currency Basket**

The RMB's addition to the basket of the SDR—the IMF's international reserve asset—took effect on October 1, 2016.† The IMF executive board decided in November 2015 that the RMB “met all existing criteria” for SDR basket inclusion, including being “freely usable,” defined as being “widely used” for international transactions and “widely traded” in major foreign exchange markets.<sup>76</sup> The decision was reportedly unanimously supported by IMF executive board members, including the United States.<sup>77</sup> The addition of the RMB to the SDR basket—currently composed of the dollar, euro, pound, and yen—has been a key policy objective for Beijing both as a symbol of its economic importance and role in the global economy and as part of its efforts to increase the international use of the RMB.<sup>78</sup>

Christine Lagarde, managing director of the IMF, said the RMB's inclusion is “a recognition of the progress that the Chinese authorities have made in the past years in reforming China's monetary and financial systems.”<sup>79</sup> Following the announcement, the PBOC pledged China “will speed up the effort to promote financial reforms and opening.”<sup>80</sup> Dr. Prasad said that while the decision will encourage China's reformers, “domestic opposition to further financial-sector reforms and market-oriented liberalization measures remains fierce, and this decision by itself is unlikely to shift the balance substantially.”<sup>81</sup>

Aside from earning China economic prestige, the immediate impact of the RMB's inclusion in the SDR basket will be limited, given the SDR's minor share of global reserves.‡ In the longer term, central banks may increase their holdings of the RMB, and investors may be encouraged to hold RMB-denominated assets. Standard Chartered, a multinational banking and financial services company, estimates the RMB's new status as a reserve asset will lead to a 1 percent shift (about \$1 trillion) of global reserves into RMB-denominated assets over the next five years.<sup>82</sup> Use of the RMB for trade settlement is still small, but has been growing steadily: according to SWIFT, a global provider of financial mes-

\*In August 2015, an unexpected move by the PBOC to cut its daily reference rate for the RMB prompted a further fall in its currency market and market selloffs. In January 2016, the PBOC's surprise move to guide the RMB weaker against the dollar sparked a second selloff. In both cases, the PBOC had to intervene heavily, using its foreign exchange reserves to prevent the RMB from falling too much. Keith Bradsher, “China to Track Renminbi Based on Basket of Currencies,” *New York Times*, December 11, 2015; Lingling Wei, “China Challenged to Keep Yuan Stable as Dollar Rises,” *Wall Street Journal*, May 16, 2016.

†Effective October 1, 2016, the weights of the SDR currencies will be: 41.7 percent for the U.S. dollar, 30.9 percent for the euro, 10.9 percent for the RMB, 8.3 percent for the Japanese yen, and 8.1 percent for the pound sterling. International Monetary Fund, “Review of the Special Drawing Right (SDR) Currency Basket,” April 6, 2016; International Monetary Fund, “IMF's Executive Board Completes Review of SDR Basket, Includes Chinese Renminbi,” November 30, 2015.

‡According to IMF data, SDR holdings made up 2.1 percent of global reserves at the end of 2014. International Monetary Fund, “IMF Annual Report 2015: Appendix I,” 2015.

### China's RMB Joins the IMF's Special Drawing Rights Currency Basket—*Continued*

saging, in July 2016 the RMB was the fifth most used currency, accounting for 1.9 percent of all international payments.\*

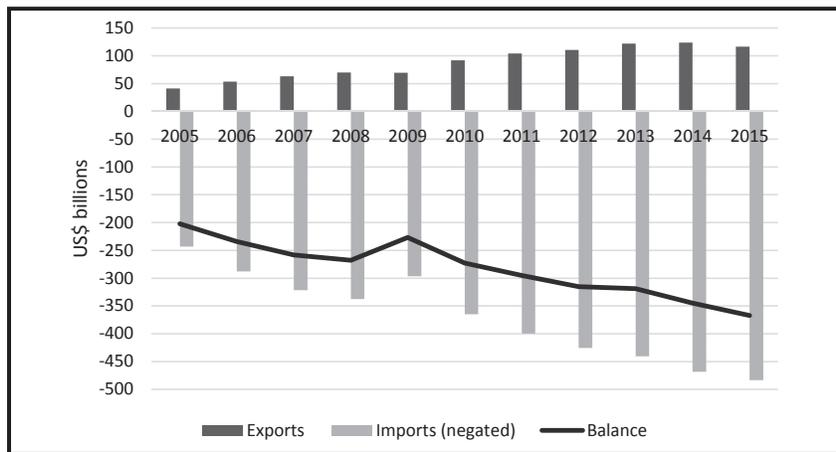
China is also pushing for greater use of the SDR as a way to reduce the dominance of the U.S. dollar.<sup>83</sup> In August 2016, the World Bank issued \$700 million worth of SDR bonds in China's domestic market for the first time, a move aimed at reviving the global market for SDR bonds.† The bonds are denominated in SDRs and payable in RMB.<sup>84</sup>

### U.S.-China Bilateral Trade and Investment

The United States is running a record trade deficit with China driven by U.S. goods imports; it has a substantial but much smaller trade surplus with China in services. Compared with bilateral trade flows, investment levels between the two countries are far smaller. In recent years, U.S. direct investment in China has remained flat, while Chinese foreign direct investment (FDI) in the United States is increasing rapidly and making up a growing share of China's outward investment.

In 2015, the U.S. goods trade deficit with China increased by 6.5 percent year-on-year to \$367.2 billion, a new record (see Figure 5).<sup>85</sup> U.S. exports to China declined 6.4 percent year-on-year to \$116 billion, while imports increased 3.6 percent to \$483.2 billion.<sup>86</sup>

Figure 5: U.S.-China Goods Trade, 2005–2015



Source: U.S. Census Bureau.

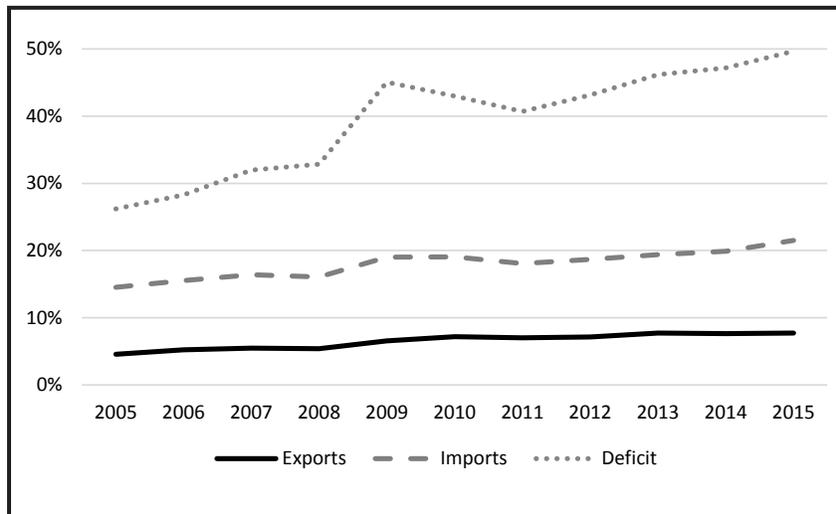
\*The U.S. dollar leads SWIFT rankings with 41.3 percent, followed by the euro (31.3 percent), pound sterling (7.9 percent), and Japanese yen (3.4 percent). SWIFT, "RMB Continues to Penetrate the South African Market," August 24, 2016.

†Analysts anticipate limited demand from commercial investors given the bonds' low yields, but China's major state-owned banks are expected to step in and buy up bonds in the absence of market demand. SDR-denominated bonds were first issued in 1975 but floundered in the 1980s due to a lack of investor demand. Pete Sweeney, "China Is Wrong Venue for an SDR Revival," September 1, 2016; Michelle Chen and John Ruwicz, "World Bank Sells Landmark SDR Bonds at Lower-End of Guidance, Challenges Loom," Reuters, August 31, 2016.

The pace of U.S. export growth to China has always been modest (for instance, U.S. exports grew 1.5 percent in 2014), falling far short of expectations. However, the 2015 decline in exports made for a disappointing new development.<sup>87</sup> The decline was driven by China's trade protectionism, weak demand in China, and a strong U.S. dollar, which made U.S. exports more expensive.<sup>88</sup> U.S. export growth to China last declined during the height of the global financial crisis, when exports fell from \$69.7 billion in 2008 to \$69.5 billion in 2009, before making a quick recovery in subsequent years.<sup>89</sup>

China's share of the U.S. goods deficit with the world also set a new record in 2015, reaching 50 percent (see Figure 6).<sup>90</sup> The overall goods deficit for 2015 was \$745.7 billion.<sup>91</sup> U.S. exports to China remained flat for the third year in a row at 8 percent of total U.S. exports.<sup>92</sup>

**Figure 6: China's Share of U.S. Goods Exports, Imports, and Deficit, 2005–2015**



Source: U.S. Census Bureau.

In the first eight months of 2016, the U.S. goods deficit with China fell 5.7 percent year-on-year to \$225.2 billion due to weaker imports (see Table 1).<sup>93</sup> U.S. imports from China in the first eight months of the year fell 5.8 percent year-on-year—a sharp contrast to the last five years.<sup>94</sup> The drop was driven by a 27.4 percent year-on-year decrease in March imports.<sup>95</sup> U.S. exports to China fell 6.3 percent year-on-year in the first eight months of 2016.<sup>96</sup> In the last two years, China's slowing economic growth has contributed to a year-on-year decline in U.S. export growth.\*

\*Meanwhile, foreign-invested enterprises (FIEs) continue to account for a significant share of China's foreign trade. According to official Chinese data, in the first half of 2016, FIEs in China

Continued

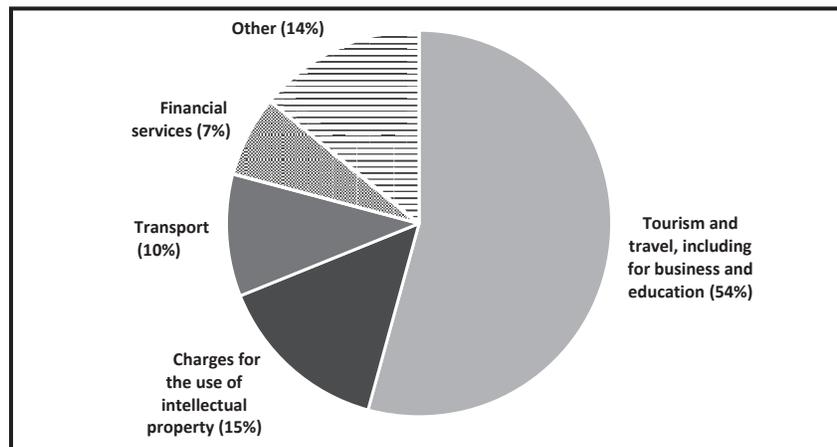
**Table 1: U.S. Goods Trade with China, January–August 2016**  
(US\$ billions)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
Exports	8.2	8.0	9.0	8.7	8.5	8.8	9.2	9.4
Imports	37.1	36.2	29.9	33.0	37.5	38.6	39.5	43.3
Balance	(28.9)	(28.1)	(20.9)	(24.3)	(29.0)	(29.8)	(30.3)	(33.9)
<i>Balance YTD</i>								
2015	(29.1)	(51.9)	(83.2)	(110.0)	(140.3)	(172.1)	(203.8)	(238.8)
2016	(28.9)	(57.0)	(77.9)	(102.2)	(131.2)	(161.0)	(191.4)	(225.2)

Source: U.S. Census Bureau.

The United States continues to maintain a sizable surplus in services, although the amount is much smaller than the U.S. deficit in goods. In 2015, the U.S. trade surplus in services with China totaled \$29.5 billion, a 5 percent increase from 2014.<sup>97</sup> Total bilateral trade in services rose approximately 7.9 percent in 2015, with U.S. service exports growing 7 percent, and Chinese service imports growing 10.5 percent.<sup>98</sup> Tourism and travel, including for business and education,<sup>\*</sup> is the top U.S. service export to China,<sup>†</sup> followed by charges for intellectual property<sup>‡</sup> (see Figure 7); travel is also the top U.S. service import from China, followed by transportation services.<sup>99</sup>

**Figure 7: U.S. Service Exports to China, 2015**



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Note: "Other" includes other business services; maintenance and repair services; telecommunications, computer, and information services; government goods and services; and insurance services.

produced 42.8 percent of China's exports and 49 percent of its imports. China's Ministry of Commerce, *Import & Export Statistics by FIEs from Jan to June 2016*, July 15, 2016.

<sup>\*</sup>Under international and U.S. standards, tourism is broadly defined to include travel and related expenses for business purposes and travel and expenses for personal purposes, such as vacation, education, and medical services. International Monetary Fund, "Balance of Payments and International Investment Position Manual," 2009; U.S. Department of Commerce, *Comprehensive Restructuring of the International Economic Accounts: New International Guidelines Redefine Travel*. <http://travel.trade.gov/pdf/restructuring-travel.pdf>.

<sup>†</sup>For more on China's tourism spending and investment in the United States, see Matt Snyder, "Chinese Tourism and Hospitality Investment in the United States," *U.S.-China Economic and Security Review Commission*, July 25, 2016.

<sup>‡</sup>Charges for the use of intellectual property include charges for the use of proprietary rights, such as patents, trademarks, copyrights, industrial processes and designs, and franchises.

The United States continued to run a deficit in advanced technology product (ATP) trade with China, but that deficit decreased by \$3 billion to \$120.7 billion from 2014 to 2015.<sup>100</sup> In the first eight months of 2016, the U.S. deficit with China in ATP reached \$67.1 billion, a \$5.9 billion decline from the same period in 2015 (see Table 2).<sup>101</sup> Imports of information and communication technology (ICT) products continue to be the main contributor to the deficit, accounting for 89 percent of total ATP imports in the first eight months of 2016.<sup>102</sup> While large, ICT imports fell 7.2 percent year-on-year in the first eight months of 2016, contributing to a slowing deficit.<sup>103</sup>

**Table 2: ATP Trade, January–August 2016**  
(US\$ millions)

	Monthly			Cumulative year-to-date			
	Exports	Imports	Balance Aug'16	Exports	Imports	Balance 2016	Balance 2015
<b>TOTAL</b>	<b>3,006</b>	<b>12,684</b>	<b>-9,678</b>	<b>22,119</b>	<b>89,240</b>	<b>-67,121</b>	<b>-73,058</b>
(01) Biotechnology	77	14	63	548	87	461	397
(02) Life Science	295	258	37	2,233	1,729	504	523
(03) Opto-Electronics	32	539	-507	303	3,783	-3,480	-3,849
(04) Information & Communications	439	11,291	-10,852	3,227	79,521	-76,294	-82,262
(05) Electronics	539	355	184	3,875	2,531	1,344	1,557
(06) Flexible Manufacturing	221	108	113	2,071	672	1,399	1,231
(07) Advanced Materials	17	34	-17	156	233	-77	-148
(08) Aerospace	1,382	69	1,313	9,494	598	8,896	9,442
(09) Weapons	0	14	-14	2	85	-83	-89
(10) Nuclear Technology	4	0	4	209	1	208	139

Source: U.S. Census Bureau.

## ***Foreign Investment Climate in China***

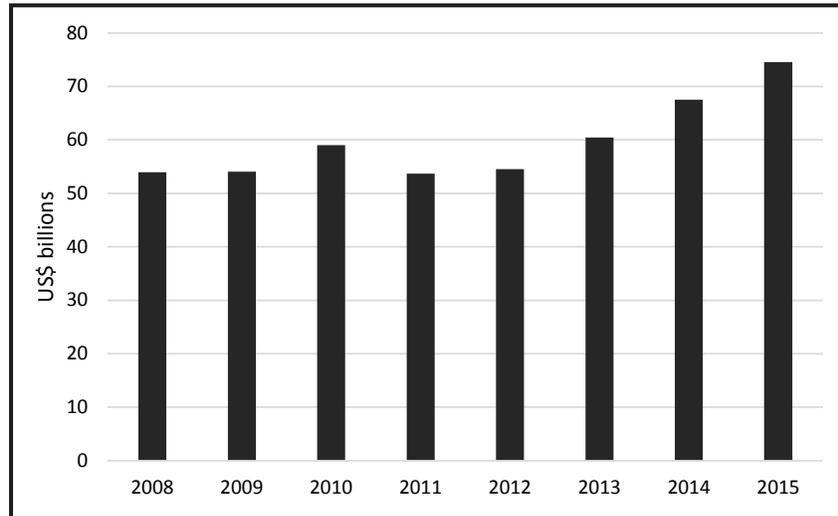
### *Trends in U.S. Direct Investment in China*

Growth in U.S. direct investment in China has stagnated over the past five years, even as overall outward U.S. direct investment has expanded.<sup>104</sup> According to the U.S. Bureau of Economic Analysis (BEA), in 2015, annual U.S. FDI in China inched up to \$7.1 billion, bringing the share of U.S. FDI flowing into China to 2 percent of total outbound U.S. FDI, the same as in 2014.\*<sup>105</sup>

From 2008 to 2015, BEA data show a steady increase in U.S. FDI stock (cumulative) in China from around \$53.9 billion to \$74.6 billion (see Figure 8).<sup>106</sup> While U.S. FDI stock in China remains considerably higher than China's FDI stock in the United States (from 2008 to 2015, China's FDI stock in the United States rose from around \$1.1 billion to \$14.8 billion), annual Chinese FDI flows into the United States have grown much faster than U.S. annual FDI flows into China.<sup>107</sup>

\*For a breakdown of U.S. FDI stock in China by sector, see U.S.-China Economic and Security Review Commission, *2015 Annual Report to Congress*, November 2015, 73–74. The latest data available are for 2014.

**Figure 8: U.S. FDI Stock in China, 2008–2015**  
(cumulative, historical-cost basis)



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

This reflects broader inbound FDI trends in China: FDI flows into China have slowed in recent years due to rising costs, concerns over the foreign investment climate, expectations for further RMB weakness, and competition from Southeast Asian countries.<sup>108</sup> Official statistics from China’s Ministry of Commerce (MOFCOM) show nonfinancial FDI in China reaching \$117 billion (RMB 781.4 billion) in 2015, a modest increase of 6.4 percent from 2014.<sup>109</sup> In the first half of 2016, nonfinancial FDI rose 5.1 percent year-on-year to \$69.4 billion; the service sector accounted for 70.4 percent of total FDI during the period, reaching \$48.9 billion.<sup>110</sup>

### ***Challenges for U.S. Companies in China***

#### *Market Access Restrictions*

China’s restrictive investment regime has earned it the second-worst rating on the Organisation for Economic Co-Operation and Development’s (OECD) FDI Regulatory Restrictiveness Index\* every year since the index’s inception in 2010.<sup>111</sup> To protect domestic industries, particularly those deemed strategic, China continues to limit foreign investment in many sectors where the United States maintains a competitive advantage, such as research and development (R&D)-intensive and value-added sectors.† Despite high-level

\*The OECD FDI Regulatory Restrictiveness Index includes both OECD economies and non-OECD member economies and is based on four main indicators: “equity restrictions, screening and approval requirements, restrictions on foreign key personnel, and other operational restrictions (such as limits on purchase of land or on repatriation of profits and capital). The discriminatory nature of measures is the central criterion to decide whether a measure should be scored.” Blanka Kalinova, Angel Palerm, and Stephen Thomsen, “OECD’s FDI Restrictiveness Index: 2010 Update,” *OECD Working Papers on International Investment* 03 (2010): 6.

†For more on China’s foreign investment restrictions, see U.S.-China Economic Security Review Commission, Chapter 1, Section 2, “Foreign Investment Climate in China,” in *2015 Annual Report to Congress*, November 2015.

commitments, China has only taken incremental steps to broaden market access for foreign investors.

China has affirmed its intent to further liberalize its foreign investment regime in several high-level documents, including the Third Plenum Decision and 13th Five-Year Plan (FYP). These documents direct China to expand foreign investment access in China, use a negative list approach\* to govern access, set up more free trade zones, and streamline its foreign investment regulatory framework.<sup>112</sup> However, the rising tide of complaints from foreign companies indicates a lack of progress on liberalization.<sup>113</sup>

The 13th FYP calls for a “fair competitive market environment, highly efficient and clean governing environment, a just and transparent legal and policy environment, and an open and inclusive cultural environment” to improve the business climate for foreign firms.<sup>114</sup> The plan encourages “expanding” market entry for foreign companies in the service sector, including banking, insurance, securities, and senior care, while “encouraging greater foreign investment” in advanced manufacturing, high-tech, conservation and environmental protection, modern services, and in central, western, and northeastern China more generally.<sup>115</sup> It also promotes expanding the construction of free trade zones and fully implementing a “pre-establishment national treatment negative list management system.”<sup>116</sup>

However, the 13th FYP also makes it clear that market access is encouraged only to the extent that greater access for foreign companies benefits China’s economic priorities. According to a report from the Center for Strategic and International Studies, “Investment is encouraged only in those sectors where China is seeking to develop domestic capacity to move up the value-added chain or in areas required by previous commitments.”<sup>117</sup> (For more on China’s 13th FYP, see Chapter 1, Section 3, “13th Five-Year Plan.”) Continued asymmetries in market access have led the Office of the U.S. Trade Representative (USTR) to conclude in its 2016 *National Trade Report on Foreign Trade Barriers* that “sustained bilateral engagement has not led to a significant relaxation of China’s investment restrictions, nor has it appeared to curtail *ad hoc* actions by Chinese government officials.”<sup>118</sup>

#### *Deteriorating Business Environment*

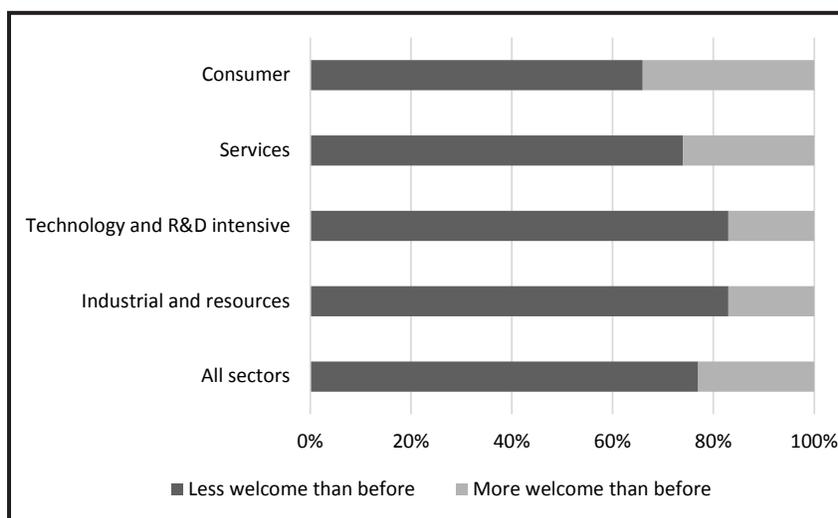
These developments have contributed to increasing pessimism among the foreign business community. According to the American Chamber of Commerce in China’s (AmCham China) 2016 Business Climate Survey, 77 percent of surveyed U.S. companies reported they felt foreign businesses are less welcome in China than in years past, while 83 percent of technology, R&D, industrial, and resources companies reported China to be less welcoming (see Figure 9).<sup>†</sup><sup>119</sup>

\*Under a negative list approach, countries specify which sectors are restricted or prohibited for foreign investment.

†AmCham China’s 2016 Business Climate Survey analyzed responses from 496 U.S. companies operating in China, representing 52 percent of the organization’s 961 member companies. Respondent companies were categorized into four sectors: services (excluding information services), information/knowledge-based services, R&D-intensive industries, and resources and industrial. Thirty-one percent of respondents forecasted a revenue of \$100 million or more for 2015. American Chamber of Commerce in the People’s Republic of China, “2016 China Business Climate Survey Report,” 2016, 8.

This represents a dramatic increase in dissatisfaction over previous years: in 2015 and 2014, less than half of U.S. companies reported feeling less welcome than before.<sup>120</sup> However, 55 percent of companies also reported improvements to the business environment due to better enforcement of Chinese government policies; in particular, companies reported marked improvements in China’s enforcement of intellectual property rights.<sup>121</sup>

**Figure 9: Percentage of U.S. Businesses Reporting China More or Less Welcoming to Foreign Business by Sector, 2016**



Source: American Chamber of Commerce in the People’s Republic of China, “2016 China Business Climate Survey Report.”

Fifty-seven percent of surveyed U.S. firms reported that “inconsistent regulatory interpretation and unclear laws”<sup>\*</sup> presented the greatest challenge to doing business in China (see Table 3).<sup>122</sup> Alongside these regulatory concerns, difficulties in obtaining Chinese licenses rose to the third most frequently cited challenge, with 29 percent of respondents identifying it as a top concern.<sup>123</sup> Industry overcapacity—a new addition to the survey in 2016—was the fifth most cited challenge for U.S. firms.<sup>124</sup> The results are mirrored in the findings of the EU Chamber of Commerce in China’s 2016 Business Confidence Survey, where over half of surveyed companies reported that doing business in China has become more difficult over the previous year, and 70 percent said they felt less welcome in China than they did ten years ago.<sup>125</sup>

<sup>\*</sup>For example, China’s Anti-Monopoly Law enforcement agencies—MOFCOM, the National Development and Reform Commission, and the State Administration of Industry and Commerce—have failed to treat identical or similar violations of the law equally, resulting in more leniency toward SOEs, more rigorous enforcement against foreign companies, and substantially varied penalties imposed on companies in similar circumstances. U.S.-China Economic and Security Review Commission, Chapter 1, Section 2, “Foreign Investment Climate in China,” in *2015 Annual Report to Congress*, November 2015, 107.

**Table 3: Top Five Business Challenges in China Reported by U.S. Firms, 2012–2016**

2012	2013	2014	2015	2016
Shortage of qualified management: 43%	Labor costs: 44%	Labor costs: 61%	Labor costs: 61%	<b>Inconsistent regulatory interpretation and unclear laws: 57%</b>
<b>Inconsistent regulatory interpretation and unclear laws: 37%</b>	<b>Inconsistent regulatory interpretation and unclear laws: 38%</b>	<b>Inconsistent regulatory interpretation and unclear laws: 39%</b>	<b>Inconsistent regulatory interpretation and unclear laws: 47%</b>	Labor costs: 54%
Shortage of qualified employees: 29%	Shortage of qualified employees: 35%	Shortage of qualified employees: 37%	Shortage of qualified employees: 42%	Obtaining required licenses: 29%
Obtaining required licenses: 26%	Corruption: 30%	Shortage of qualified management: 31%	Shortage of qualified management: 32%	Shortage of qualified employees: 29%
Corruption: 26%	Shortage of qualified management: 30%	Obtaining required licenses: 31%	Increasing Chinese protectionism: 30%	<b>Industry overcapacity: 29%</b>

*Source:* American Chamber of Commerce in the People's Republic of China, "2016 China Business Climate Survey Report."

### *Information and Communications Technology and Cybersecurity Policies*

Over the past several years, the foreign investment climate for companies in the information and communications technology (ICT) sector has worsened, as Beijing has strengthened oversight and control over foreign companies. Part of this reflects an unprecedented drive under the Xi Administration to deliver on domestic industrial innovation goals.<sup>126</sup> Through two central government plans, the "Made in China 2025" initiative and the "Internet Plus" plan introduced in 2015, President Xi has increased state support for domestic technology companies, putting foreign companies at a competitive disadvantage.<sup>127</sup> (For more on these initiatives, see Chapter 1, Section 3, "13th Five-Year Plan.")

National security is the other key driver behind China's increasingly tough line on foreign technology companies.<sup>128</sup> Emboldened by allegations in 2013 regarding the U.S. government's use of U.S. companies to conduct cyber espionage, along with a more general desire to increase Chinese authorities' ability to monitor domestic Internet discourse and activity, Beijing has argued it must reduce its dependence on foreign technology.<sup>129</sup> Over the past year, Beijing has introduced stricter ICT requirements and stronger cybersecurity policies. Many of these measures involve "secure and controllable" technology requirements; while the term is not clearly defined, foreign companies and industry groups fear it would compel foreign companies to give the Chinese government

access to networks, encryption keys, and source code, as well as require data storage within the country.<sup>130</sup>

China's State Council has codified these policies in three security laws: the National Security Law, Counterterrorism Law, and Cybersecurity Law. Passed in July 2015, the National Security Law serves as an umbrella statute bolstering state control across all sectors of the economy under a broad definition of national security, and enshrines the concept of cyberspace sovereignty in national law.<sup>131</sup> The law lays the groundwork for more formalized national security review of inbound foreign investment.<sup>132</sup> The Counterterrorism Law, passed in December 2015, requires telecommunications and Internet service providers (ISPs) to assist Chinese security agencies with decryption and other "technological assistance and support" in terrorism cases, leaving out controversial requirements present in earlier drafts of the law that firms provide security "backdoors" to authorities and store server and user data locally.\*<sup>133</sup> Finally, a draft Cybersecurity Law released in July 2015 mandates data localization and cybersecurity reviews, but offers no details on what the reviews will entail.<sup>134</sup> In general, the language in these laws is broad and vague, and is expected to be clarified in forthcoming implementing regulations. Some analysts are concerned the more worrisome requirements will be rolled into the implementing regulations, or that the provisions may be kept deliberately vague to give authorities flexibility in their enforcement.<sup>135</sup>

The term "secure and controllable" has also cropped up in a series of industry-specific regulations over the past year, including in the insurance, e-commerce, and cloud computing sectors.<sup>136</sup> A high-profile example was a draft bank technology measure that called for 75 percent of technology products used by Chinese financial institutions to be "secure and controllable" by 2019.<sup>137</sup> The rules were temporarily suspended in April 2015 after feedback from Chinese banks as well as pressure from the U.S. government, industry groups, and technology firms.<sup>138</sup> Although many of these regulations are still pending, the Chinese government has already begun to implement them by asking foreign vendors to certify they are "secure and controllable."<sup>139</sup> The Chinese government's clear commitment to reduce the country's reliance on foreign technology and linkage of localization and security means these security standards are unlikely to go away. Chinese technology companies have a distinct competitive advantage in meeting these new security standards, putting pressure on foreign firms to partner with local companies.<sup>140</sup>

### **U.S. Tech Firms and Their Chinese Partners**

There is evidence of U.S. technology firms forming or deepening partnerships with Chinese firms as a result of pressure from Beijing to localize product development and data.† In 2013, Chi-

\*For more information on China's draft counterterrorism law, see U.S.-China Economic and Security Review Commission, Chapter 2, Section 4, "Commercial Cyber Espionage and Barriers to Digital Trade in China," *2015 Annual Report to Congress*, November 2015, 215–216.

†Examples of pressure include antitrust investigations, data localization requirements, and security reviews. Eva Dou, "China's Tech Rules Make It Hard for U.S. Firms to Take Control," *Wall Street Journal*, June 2, 2016; Paul Mozur and Jane Perlez, "China Quietly Targets U.S. Tech Companies in Security Reviews," *New York Times*, May 16, 2016; and U.S.-China Economic and Security Review Commission, *Hearing on Foreign Investment Climate in China: Present Challenges and Potential for Reform*, written testimony of Robert D. Atkinson, January 28, 2015.

### **U.S. Tech Firms and Their Chinese Partners—Continued**

nese state media labeled eight U.S. technology firms—Cisco, IBM, Google, Qualcomm, Intel, Apple, Oracle, and Microsoft—“guardian warriors” of U.S. interests that had “infiltrated” the Chinese market.<sup>141</sup> Of the eight firms, six have since found it necessary to work with local partners to expand their business in China.<sup>142</sup>

- In 2014, IBM agreed to share proprietary technology with Chinese information technology (IT) provider Teamsun to help the company develop a full supply chain of computers and software based on IBM technology.<sup>143</sup>
- In June 2015, Cisco formed a joint venture with Chinese server maker Inspur on localized cloud computing and networking products.<sup>144</sup>
- In December 2015, Microsoft partnered with Chinese state-owned China Electronics Technology Group (CETC) to develop a version of Windows 10 for Chinese government users.<sup>145</sup>
- In January 2016, Qualcomm formed a joint venture with the Guizhou provincial government to make server chips customized for Chinese customers.<sup>146</sup> Several months earlier, Qualcomm formed a joint venture company with China’s largest chipmaker, SMIC, and Huawei\* to develop next-generation semiconductor technology;† this came just four months after the company received a \$975 million fine from Chinese anti-trust regulators.<sup>147</sup>
- In January 2016, Intel announced a “strategic collaboration” with state-controlled Tsinghua University and Montage Technology Global Holdings Ltd. to develop custom computer processors that satisfy Chinese security requirements.<sup>148</sup>
- In May 2016, Apple invested \$1 billion in Didi Chuxing, China’s top private ride-sharing company.<sup>149</sup>

U.S. technology firms have largely resisted pressure from Beijing to share their product source code; doing so would reveal their core intellectual property and increase the risk of intellectual property theft.<sup>150</sup> In 2015, however, IBM said it had agreed

\*Huawei’s close ties to the Chinese government have long concerned U.S. government officials. A 2012 U.S. House Intelligence Committee panel report found that Huawei’s penetration of the U.S. telecommunications market poses risks to national security. In August 2016, AT&T announced it had begun preliminary discussions with several technology companies, including Huawei, to create global standards for the 5G network. According to media reports, a formal review led by the National Security Agency and the Federal Bureau of Investigation is underway to examine the national security implications of Huawei’s potential participation in building the U.S. 5G wireless network. Eli Lake, “U.S. Spies Think China Wants to Read Your E-Mail,” *Bloomberg*, September 13, 2016; AT&T, “AT&T Teams up with Global Technology Leaders for Faster 5G Deployment,” August 17, 2016; and Mike Rogers and C.A. Dutch Ruppertsberger, “Investigative Report on the U.S. National Security Issues Posed by Chinese Telecommunications Companies Huawei and ZTE,” *House Permanent Select Committee on Intelligence*, October 8, 2012.

†For more details on this case, see U.S.-China Economic and Security Review Commission, Chapter 1, Section 2, “Foreign Investment Climate in China,” in *2015 Annual Report to Congress*, November 2015, 96–97.

**U.S. Tech Firms and Their Chinese Partners—Continued**

to allow the Chinese government to review some of its product source code in a controlled environment.\*

China is also intensifying its advocacy of “cyber sovereignty” as a global regulatory norm. In his keynote address at the second annual World Internet Conference in December 2015, President Xi argued for “the right of individual countries to independently choose their own path of cyber development, model of cyber regulation and Internet public policies, and participate in international cyberspace governance on an equal footing” and defended Beijing’s Internet censorship.<sup>151</sup> Chinese authorities have shifted away from not publicly admitting China’s censorship efforts to using the concept of “cyber sovereignty” to argue for increased government control of the Internet. According to Samm Sacks, a China technology policy analyst at the Eurasia Group, the Chinese government’s intense advocacy of sovereignty in cyberspace “could eventually over the long term lead to fragmentation of the U.S.-led global Internet.”<sup>152</sup>

*Update on China’s Commercial Cyber Espionage*

In addition to enacting ICT and cybersecurity policies aimed at extracting technologies from U.S. companies, China has conducted cyber theft operations to gain access to U.S. intellectual property and technology. Pervasive Chinese cyber espionage against U.S. commercial entities—detailed in the Commission’s *2015 Annual Report to Congress*†—continues to pose a grave threat to U.S. economic security despite China’s agreement in 2015 not to support commercial cyber espionage conducted by Chinese actors. In a September 2015 memorandum of understanding (MOU), the United States and China pledged that “neither country’s government will conduct or knowingly support cyber-enabled theft of intellectual property, including trade secrets or other confidential business information, with the intent of providing competitive advantages to companies or commercial sectors.”<sup>153</sup> (For a discussion of China’s non-commercial cyber espionage activities, see Chapter 2, Section 3, “China’s Intelligence Services and Espionage Threats to the United States.”)

Public reports suggest Chinese cyber espionage against U.S. companies persists, but has declined in frequency since September 2015.<sup>154</sup> It is unclear whether this trend is attributable to the MOU.<sup>155</sup> FireEye, a cybersecurity firm, reported in June 2016 that a precipitous drop in detected incidents of Chinese cyber espionage against U.S. companies began more than one year before the MOU came into effect.<sup>156</sup> Notably, the beginning of this decline roughly coincided with the U.S. Depart-

\* IBM said in a statement it “has in several countries established the capability to conduct limited demonstrations of specific aspects of [its] technology in highly-controlled IBM environments that have no external communication links.” According to the company, its intent in sharing some product source code was “to reassure key stakeholders, including our clients, that no means exist for other parties to access IBM technology or data we manage on behalf of clients.” IBM further maintained it “does not provide government access to client data or ‘back doors’ into [its] technology.” IBM, “IBM Statement on Limited Technology Demonstrations,” October 16, 2015.

† U.S.-China Economic and Security Review Commission, Chapter 1, Section 4, “Commercial Cyber Espionage and Barriers to Digital Trade in China,” in *2015 Annual Report to Congress*, November 2015, 192–225.

ment of Justice’s May 2014 indictment of five People’s Liberation Army (PLA) officers for cyber espionage against U.S. companies.<sup>157</sup> Moreover, although the number of incidents of Chinese cyber espionage detected by FireEye has declined, this likely reflects a shift within China away from prolific amateur attacks toward more centralized, professionalized, and sophisticated attacks by a smaller number of actors, rather than a trend toward the cessation of Chinese cyber espionage.<sup>158</sup> According to a report from the U.S. Department of State Overseas Security Advisory Council, many studies suggest “China-based network intrusions are still ongoing, only a fraction of which may be detected by researchers.”<sup>159</sup> In the words of one expert consulted by the Commission, while some of China’s “noisier” cyber espionage efforts have ceased, its “A-team [of sophisticated hackers] has gone deeper.”<sup>160</sup> President Xi’s efforts to consolidate control over the PLA—some of whose employees have supplemented their incomes by operating outside their chains of command to conduct cyber espionage on behalf of third parties—as well as political pressure generated by the MOU and international attention to Chinese cyber espionage activities could have contributed to this trend.\*<sup>161</sup> Some noteworthy reports of Chinese commercial cyber espionage since September 2015 include:

- In the three weeks following the U.S.-China cyber MOU, cybersecurity firm CrowdStrike observed 11 instances of intrusions by Chinese government-affiliated actors into U.S. technology and pharmaceutical companies; the first of these intrusions occurred the day after the MOU was signed. CrowdStrike assessed each of these incidents “fit squarely within the hacking provisions covered under the cyber agreement.”<sup>162</sup>
- FireEye reported several instances of what appeared to be China-based groups compromising several U.S.-owned or U.S.-based software, semiconductor, and other high-technology corporations, as well as a U.S. healthcare organization, in the first five months of 2016.<sup>163</sup>
- In April 2016, Admiral Michael S. Rogers, commander of the U.S. Cyber Command, testified to the Senate Armed Services Committee that since September 2015, “cyber operations from China are still targeting and exploiting U.S. government, defense industry, academic, and private computer networks.”<sup>164</sup>

Chinese cyber espionage threatens the economic competitiveness of U.S. companies. According to one analyst—Jeffrey Johnson, president and CEO of SquirrelWerkz, a cyber, competitive, and economic threat intelligence firm— Chinese actors have consistently applied a sophisticated commercial espionage campaign strategy against U.S. companies involving a combination of cyber espionage and human infiltration to systematically penetrate strategic organizations and information systems of U.S. companies to steal their intellectual property, sabotage operations, devalue

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\*The value of the MOU, according to one expert who met with the Commission, is not that it will lead to a cessation of Chinese cyber espionage against U.S. companies, but rather that it establishes a mutually agreed-upon bilateral standard for behavior in cyberspace and a blueprint for an international norm against which China’s actions can be scrutinized. U.S.-China Economic and Security Review Commission, private discussion with cybersecurity experts, June 9, 2016.

them, and position them for acquisition at dramatically reduced prices.<sup>165</sup> According to Mr. Johnson,

*In the case of the cyber-economic campaign against the U.S. mobile phone industry, evidence supports a conclusion that the government of China worked in collusion with a number of Chinese companies to optimize cyber-economic sabotage to degrade Western mobile provider performance; conduct espionage to accelerate its own development of critical components and competitive mobile devices; introduce significant barriers to performance within the Chinese market for purposes of degrading the value of the Western competitors after having gained from their investments into China and to deprive the same companies of the traditional returns; introduce additional duress through state sponsored legal actions; and leverage cyber intelligence to optimize the timing of these events and obstacles. The same pattern exists in at least 10 other key industries.<sup>166</sup>*

The threat from Chinese commercial espionage is unlikely to subside as China's cyber espionage operations are poised to become more sophisticated and well coordinated.<sup>167</sup> Notably, the September 2015 MOU does not prohibit state-sponsored cyber espionage operations to support national security.<sup>168</sup> As China views economic security as a component of national security, it likely does not perceive many of its commercial cyber espionage activities as a violation of the MOU.

#### **U.S. Steel's Section 337 Case against China**

In April 2016, U.S. Steel filed a complaint with the U.S. International Trade Commission (ITC) under Section 337 of the Tariff Act of 1930. This law allows the ITC to ban products made through unfair methods of competition, including theft of intellectual property, from the U.S. market.<sup>169</sup> The firms listed in U.S. Steel's petition include some of China's largest steel producers and their distributors.<sup>170</sup> U.S. Steel alleged these firms colluded to fix prices and control production and export volumes, and engaged in false labeling to circumvent trade duties.<sup>171</sup> U.S. Steel also alleged Chinese government hackers stole U.S. Steel's proprietary methods for making advanced high-strength steel, one of the company's most valuable products, and provided this information to Chinese steel firms.\*<sup>172</sup> U.S. Steel alleged that at least one Chinese firm, Baosteel, began producing and exporting advanced high-strength steel using these stolen trade secrets, undercutting U.S. Steel's own products.<sup>173</sup> The ITC announced its plans to initiate a Section 337 investigation in May 2016.<sup>174</sup> If successful, U.S. Steel's Section 337 case could provide U.S. companies with a new use of an existing tool to combat cyber theft of trade secrets by foreign companies or governments.<sup>175</sup>

\*The alleged cyberattack on U.S. Steel was among those included in a criminal case brought by the U.S. Department of Justice against five PLA officers in May 2014. U.S. Department of Justice, Office of Public Affairs, *U.S. Charges Five Chinese Military Hackers for Cyber Espionage against U.S. Corporations and a Labor Organization for Commercial Advantage*, May 19, 2014.

### *Internet Censorship*

As a result of Beijing's desire to tighten government control over freedom of speech, Internet censorship has worsened. In April 2016, the USTR listed China's Internet censorship in its *2016 National Trade Estimate on Foreign Trade Barriers* as a "significant burden" on foreign suppliers wishing to do business in China.<sup>176</sup> The USTR noted that China's Internet restrictions affected both foreign Internet content providers and businesses that rely on Internet services for their operations.<sup>177</sup> While the report did not propose any official actions to address China's Internet restrictions, it explicitly described China's censorship as a trade barrier; previous reports characterized China's Internet regime as being merely "restrictive and non-transparent."<sup>178</sup> The report also stated that China's restrictions appear "to have worsened over the past year, with eight of the top 25 most trafficked global sites now blocked in China."<sup>179</sup>

China's online censorship apparatus—known as the Great Firewall—is regarded as the most extensive in the world, and a 2015 ranking by Freedom House found China to be the world's worst abuser of Internet freedom.<sup>180</sup> The number of blocked sites is increasing. According to Internet watchdog GreatFire.org, about 14 percent of the sites it monitors were blocked in China when President Xi took office in 2013.<sup>181</sup> As of April 2016, almost a full quarter of the online content GreatFire.org monitors is blocked in China.<sup>182</sup>

Estimating the revenue U.S. companies lose from Chinese censorship is difficult.\* Many U.S. companies decline to publicly disclose their losses associated with Chinese Internet restrictions. During a press investigation last year, Google, Dropbox, Snapchat, and several other companies that are routinely blocked in China chose not to discuss costs resulting from Chinese restrictions.<sup>183</sup>

The Chinese government took further steps to strengthen control over the Internet by issuing new regulations that limit access to the country's multibillion-dollar online content market.† In February 2016, China's State Administration of Press, Publication, Radio, Film and Television (SAPPRFT) released the *Administrative Regulations for Online Publishing Services*, which restricts foreign companies—including foreign joint ventures—from distributing online content in China except on a project basis with Chinese partners.<sup>184</sup> The regulation applies to online distribution of games, video, books, newspapers, animations, pictures, articles, and other online content

\*These losses are likely significant, given the growing size of China's Internet population—668 million online users as of the end of 2015. For example, the *New York Times* disclosed it lost \$3 million in the first year after it was blocked by Chinese authorities after reporting on the wealth of China's then prime minister Wen Jiabao's family. Google has frequently seen its services blocked or slowed by Chinese regulators. In 2014, the company made an estimated \$1 billion in advertising revenue in China—largely from Chinese companies that place ads to attract foreign buyers. If Google had the same share of China's advertising market before its search engine was restricted in 2010—roughly 36 percent—the company likely would have made \$3.5 billion from Chinese advertising in 2014, almost 5 percent of its total revenue. Marco Huang, "More Than Half of China's Population Is Online—And Most Use Smartphones," *Wall Street Journal*, January 26, 2016; Julie Makinen, "Chinese Censorship Costing U.S. Tech Firms Billions in Revenue," *Los Angeles Times*, September 22, 2015; and Margaret Sullivan, "The Thorny Challenge of Covering China," *New York Times*, December 7, 2013.

†China's online content market is one of the largest in the world. In 2012 China had more than twice as many viewers of online videos as the United States, and the Chinese digital audience is projected to increase to 700 million people in 2016. Total revenue from Chinese digital videos is predicted to reach \$3.95 billion in 2016 (from \$1.86 billion in 2013). David Barboza, "New Chinese Rules on Foreign Firms' Online Content," *New York Times*, February 19, 2016; Go-globe.com, "Online Video Market in China," January 6, 2014.

to be designated by SAPPRFT at a later date.<sup>185</sup> The measure's broad scope makes it difficult to predict which companies will be affected. While China bans many U.S. online content companies, the new regulation may affect U.S. companies already operating in China.\* As one analyst noted, it was unclear whether a company that "just had an instruction manual online" would be subject to these rules.<sup>186</sup> Some analysts have argued the measure may only apply to content created in China and thus may not affect foreign firms at all.<sup>187</sup> Most analysts agree the impact of this regulation will depend heavily on how it is implemented.<sup>188</sup>

In a move to further tighten online censorship, in July 2016 China's Internet regulator ordered several major Chinese Internet companies, including Sina, Tencent, and NetEase, to shut down or "clean up" their online news sites.<sup>189</sup> In recent years, many Chinese Internet companies have hired investigative journalists to conduct original reporting, in a bid to increase readership and revenue.<sup>190</sup> The practice had been operating in a regulatory gray zone but was largely tolerated by regulators.<sup>191</sup> Following the ban, online news sites can only carry articles provided by the state media.<sup>192</sup>

#### *Foreign Nongovernmental Organization Law*

China has tightened control over the activities of foreign nongovernmental organizations (NGOs). In April 2016, the Chinese government approved the Law on the Management of Foreign NGO Activities in Mainland China, which places greater state oversight on more than 7,000 foreign NGOs in China and gives the government broad powers to inspect NGO offices and operations.<sup>†</sup><sup>193</sup> According to AmCham China's 2016 Business Climate Survey, 75 percent of NGO respondents reported that the law as it existed in 2015 would limit the scope of their operations in China, and 17 percent reported that it would cause them to leave the country.<sup>194</sup>

U.S. businesses lobbied the Chinese government to remove provisions included in the current law. In June 2015, 45 U.S. industry associations signed a letter urging the Chinese government not to place NGOs under the management of security forces and to narrowly define NGOs to exclude groups such as trade and professional associations.<sup>‡</sup><sup>195</sup> The letter noted that if the law were passed "without major modifications," it would "have a significant adverse impact

\*For example, Apple currently runs a Chinese app store that provides games and software, and Microsoft offers Windows products online through a Chinese joint venture. Vimeo and Amazon also run online distribution platforms in China and may be affected. David Barboza, "New Chinese Rules on Foreign Firms' Online Content," *New York Times*, February 19, 2016; Scott Livingston, "A Guide to China's New Online Publishing Rules for Foreign Media," *Techcrunch.com*, February 23, 2016.

†The law's broad language gives Chinese authorities a wide degree of latitude in admitting, monitoring, and closing foreign NGOs. To establish an office in China, NGOs must seek the permission of the security ministry, and NGOs with existing offices in China must also obtain permission to register. Chinese security forces can enter NGO offices, seize bank accounts and property, and interrogate NGO staff if they suspect the NGO is engaged in vaguely defined activity such as damaging the national interest. Similarly, NGOs can be closed if they are found to violate these broadly worded interests. ChinaLawTranslate.com, "2016 PRC Law on the Management of Foreign Non-Governmental Organizations' Activities within Mainland China."

‡U.S. business groups argued the draft was worded broadly enough that it appeared to apply to foreign universities, industry organizations, and professional associations. The law as passed defines foreign NGOs as "not-for-profit, non-governmental social organizations lawfully established outside mainland China such as foundations, social groups, and think tank institutions." While foundations and think tanks are specifically identified as falling under the law, the definition is not limited to them and may be applied to any nonprofit, nongovernment organization—a classification that includes universities and business organizations. ChinaLawTranslate.com, "2016

on the future of U.S.-China relations” and negatively impact Chinese commerce.<sup>196</sup> In the letter, U.S. business representatives also cited the key role nonprofit organizations such as universities and trade associations play in their operations, calling them an “integral part” of their business practices.<sup>197</sup> Nevertheless, not every U.S. industry organization has stated that the law will have a negative effect on U.S. companies. For instance, the president of the US-China Business Council commented that the new law will have a relatively minor impact on U.S. industry compared to other concerns businesses have in China, noting, “By and large, American companies will not be impacted by the NGO law; companies are more directly impacted by the market access and level playing field concerns.”<sup>198</sup>

### ***Chinese Investment in the United States***

While Chinese investment remains a small percentage of total inward FDI in the United States,\* it is rising rapidly, driven by the Chinese government’s “going out” strategy, capital flight, and a generally more open policy environment for outbound investment.<sup>199</sup> A more pronounced slowdown in economic growth has also spurred Chinese investment abroad as Chinese companies seek to diversify their investments.<sup>200</sup> Chinese investment in the United States grew to a record \$15 billion in 2015 from \$11.9 billion in 2014, according to data from Rhodium Group.<sup>201</sup> In 2016, Chinese FDI appears set to surpass 2015’s record, with at least \$30 billion worth of deals in the pipeline (see Table 4).<sup>202</sup>

**Table 4: Notable Chinese Bids and Acquisitions of U.S. Companies, 2015–2016**

<b>Chinese Buyer</b>	<b>U.S. Target</b>	<b>Price (US\$ billions)</b>	<b>Status</b>	<b>Industry</b>
AVIC Auto; Bohai Harvest RST (BHR)	Henniges Automotive	\$0.60	Deal closed, Sep. 2015	Automotive
Fosun International Ltd.	Ironshore Inc.	\$1.84	Deal closed, Nov. 2015	Financial services
Dalian Wanda	World Triathlon Corp.	\$0.65	Deal closed, Nov. 2015	Sports

PRC Law on the Management of Foreign Non-Governmental Organizations’ Activities within Mainland China”; ChinaLawTranslate.com, “Changes Anticipated in the New FNGO Law.”

\*This section relies on private estimates of Chinese FDI in the United States. Both U.S. and Chinese official statistics underestimate the volume of Chinese investment because they do not fully account for flows of FDI, including investment routed through Hong Kong and other offshore financial centers. Official data are also provided after a significant delay, hindering analysis. For example, as the International Trade Administration (ITA), a bureau within the U.S. Department of Commerce, stated in a 2013 report, estimates from Rhodium Group showed \$6.5 billion of FDI flows from China to the United States in 2012, while U.S. government estimates showed only \$219 million for the same year. 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. U.S. Department of Commerce, International Trade Administration, *Report: Foreign Direct Investment (FDI) in the United States from the China and Hong Kong SAR*, July 17, 2013.

**Table 4: Notable Chinese Bids and Acquisitions of U.S. Companies, 2015–2016—Continued**

Chinese Buyer	U.S. Target	Price (US\$ billions)	Status	Industry
Uphill Investment Co. (Chinese consortium)	Integrated Silicon Solution, Inc.	\$0.74	Deal closed, Dec. 2015	Semiconductors
Dalian Wanda	Legendary Entertainment	\$3.5	Deal closed, Mar. 2016	Entertainment
Beijing E-Town Dragon Semiconductor Industry Investment Center	Mattson Technology	\$0.30	Deal closed, May 2016	Semiconductors
Haier Group	General Electric home appliances unit	\$5.6	Deal closed, Jun. 2016	Home appliances
Anbang	Fidelity & Guaranty Life	\$1.57	Pending, agreed to acquire Nov. 2015	Financial services
Chongqing Casin Enterprise Group	Chicago Stock Exchange	n/a	Pending, agreed to acquire Feb. 2016	Financial services
Tianjin Tianhai	Ingram Micro	\$6.0	Pending, agreed to acquire Feb. 2016	Electronics & IT
Anbang	Blackstone Group Strategic Hotels & Resorts Inc.	\$6.5	Pending, agreed to acquire Mar. 2016	Real estate
Humanwell Healthcare, PuraCap Pharmaceutical	Epic Pharma	\$0.55	Pending, agreed to acquire Mar. 2016	Pharmaceuticals
Zhongwang USA LLC	Aleris Corp.	\$2.3	Pending, agreed to acquire Aug. 2016	Aluminum

Source: Various.<sup>203</sup>

According to research from Rhodium Group, private Chinese companies accounted for 84 percent of total Chinese FDI in the United States in 2015, up from 19 percent five years ago, as investments by Chinese state-owned firms fell sharply.\* (For more on the thin line between Chinese state-owned companies and private companies, see

\*Rhodium Group defines private companies as companies with less than 20 percent government ownership. Thilo Hanemann and Cassie Gao, "Chinese FDI in the US: 2015 Recap," *Rhodium Group*, January 19, 2016; Thilo Hanemann and Adam Lysenko, "Chinese FDI in the United States: Q1 2013 Update," *Rhodium Group*, April 30, 2013.

Chapter 1, Section 2, “State-Owned Enterprises, Overcapacity, and China’s Market Economy Status.”) Mergers and acquisitions (M&A) remained the dominant form of FDI flows that year, with Chinese companies completing over 100 M&A deals worth \$13.5 billion.<sup>204</sup> The trend of growing Chinese FDI in the United States reflects a broader shift in China’s outbound FDI away from natural resource extraction and energy in developing countries toward a broader range of industries in high-income economies, such as Europe and the United States.<sup>205</sup>

The sectoral composition of Chinese investment in the United States has become much more diverse.<sup>206</sup> In 2015, the biggest industries were real estate and financial services, followed by ICT, energy, automotive, health and biotechnology, and entertainment. About two-thirds of total investment went into services, up from 14 percent in 2009.<sup>207</sup> The top three destinations for Chinese FDI were New York (led by investments in the financial services and real estate sectors), California (ICT and real estate), and Texas (energy).<sup>208</sup>

The increased acquisition of U.S. assets by Chinese companies has led to growing political concern over the national security risks of such acquisitions.<sup>209</sup> Chinese firms, which often receive state funding, have been particularly active in bidding for U.S. technology assets. For example, technology distributor Ingram Micro announced in February 2016 that it was being sold to Tianjin Tianhai Investment for \$6 billion.<sup>210</sup> While many analysts anticipate the sale will go forward without a Committee on Foreign Investment in the United States (CFIUS) review, a few attempted Chinese acquisitions of U.S. technology firms have recently fallen apart as a result of CFIUS scrutiny or even just its likelihood.<sup>211</sup> In February, hard disk drive manufacturer Western Digital’s sale to China’s Unisplendor collapsed after CFIUS announced it would review the deal, and the sale of the lighting division of Dutch electronics firm Royal Philips was purportedly blocked by CFIUS.<sup>212</sup> Fairchild Semiconductor, another electronics firm, rejected a bid from a Chinese buyer in February for fear the acquisition would trigger a CFIUS review.<sup>213</sup>

In another example, the acquisition of insurance company Ironshore by Chinese conglomerate Fosun International came under CFIUS review after the deal closed in November 2015.\* Media reports indicate the purchase drew CFIUS’s interest because an Ironshore subsidiary, Wright USA, is a key provider of legal liability insurance for U.S. intelligence officials.<sup>214</sup>

Overall, the data do not demonstrate that CFIUS has been a significant obstacle for Chinese investment in the United States. In 2014, the latest year for which data are available, China led foreign countries in CFIUS reviews with 24 reviewed transactions out of more than 100 total Chinese acquisition deals.<sup>215</sup> Although the number of Chinese transactions reviewed increased in absolute terms, it declined as a share of all Chinese acquisitions, and the vast majority of reviewed transactions proceed. As a percentage of total

\*News of the CFIUS review first broke in June 2016. Fosun issued a statement that it and Ironshore had voluntarily notified CFIUS of the acquisition and both parties “have been working closely with CFIUS.” Ironshore stated in a July 2016 filing for a U.S. initial public offering that it expects the results of the CFIUS review before its registration statement becomes effective. Josh Beckerman, “Fosun Group Insurance Unit Ironshore Inc. Files for IPO in U.S.,” *Wall Street Journal*, July 22, 2016; Fosun, “Fosun’s Statement,” June 4, 2016. [www.fosun.com/language/en/p/8473.html](http://www.fosun.com/language/en/p/8473.html).

Chinese acquisition deals, the number of CFIUS-reviewed Chinese transactions has decreased every year since 2012.<sup>216</sup>

A number of China's M&A deals have unraveled, in some cases due to regulatory concerns, in others due to the inability of Chinese buyers to follow through with financing (see Table 5). According to data from international financial software firm Dealogic, nearly half of the unsolicited offers made by Chinese companies over the past five years have failed.<sup>217</sup> Notably, in March 2016 the Chinese insurance giant Anbang surprised Starwood Hotels & Resorts Worldwide by abandoning its \$14 billion bid for the hotel chain, without offering a full explanation.\* Worried about the ability of Chinese companies to secure financing or pass CFIUS review, a growing number of U.S. acquisition targets are asking for escrow accounts or letters of credit to guarantee deal financing or breakup-fee payments.<sup>218</sup>

Chinese investment in the United States is expected to grow, but perhaps at a more moderate pace than the breakneck speed of the first quarter of 2016.<sup>219</sup> With increased M&A activity, Chinese companies face rising pressure from U.S. business and government stakeholders to be transparent, particularly with regard to ownership structure, corporate governance, and funding sources.<sup>220</sup> The increasingly high leverage of Chinese companies† also places financial constraints on their ability to pursue new investment opportunities overseas.<sup>221</sup>

**Table 5: Failed Chinese Bids for U.S. Companies, 2015–2016**

Chinese Buyer	U.S. Target	Price (US\$ billions)	Status	Industry
Montage	Pericom Semiconductor Corp.	\$0.4	Pericom rejected bid, citing a lack of committed financing and potential regulatory hurdles in China, Taiwan, and the United States, Nov. 2015	Semiconductors
Tsinghua Unigroup	Micron	\$23.0	Micron rejected bid, citing concerns over CFIUS approval, Feb. 2016	Semiconductors

\*Anbang said it was withdrawing its offer “due to various market considerations.” However, Caixin reported that Anbang’s decision likely stemmed from fears that China’s insurance regulator would reject its bid to buy Starwood, since it would put Anbang’s offshore assets above a 15 percent threshold for overseas investments. Chinese regulators’ concerns over Anbang’s reliance on high-cost borrowing for its overseas acquisitions may have been another contributing factor. In a panel discussion days before Anbang withdrew its bid, China’s former Minister of Commerce Chen Deming said the company should not use high leverage to acquire overseas assets, warning that “it will leave us with systemic risks.” Esther Fung, “Anbang: What We Know and Don’t Know,” *Wall Street Journal*, August 23, 2016; Greg Roumeliotis and Matthew Miller, “China’s Anbang Abandons \$14 Billion Bid to Buy Starwood Hotels,” Reuters, April 1, 2016; and Ding Feng, “Regulator Said Close to Rejecting Insurer’s Plans for Foreign Hotel Investments,” Caixin, March 22, 2016.

†According to data from S&P Global Market Intelligence, the median debt-to-equity ratio of Chinese buyers since the beginning of 2015 has been 71 percent, compared to 44 percent for foreign targets. *Economist*, “Money Bags: China’s Global Investment Spree Is Fueled by Debt,” April 2, 2016.

**Table 5: Failed Chinese Bids for U.S. Companies, 2015–2016—Continued**

<b>Chinese Buyer</b>	<b>U.S. Target</b>	<b>Price (US\$ billions)</b>	<b>Status</b>	<b>Industry</b>
China Resources Microelectronics Ltd. and Hua Capital	Fairchild Semiconductor	\$2.5	Fairchild turned down bid over fears it would be blocked by CFIUS; accepted takeover offer from U.S. rival ON Semiconductor, Feb. 2016	Semiconductors
GO Scale Capital	Philips Lumileds	\$2.8	Buyer withdrew after CFIUS blocked the deal, Jan. 2016	Lumileds & Automotive Lighting
Unisplendor	Western Digital	\$3.8	Buyer withdrew after CFIUS announced investigation, Feb. 2016	Electronics
Anbang	Starwood Properties	\$14.0	Buyer withdrew bid, Mar. 2016	Real estate
Origin Technologies Corp.	Affymetrix Inc.	\$1.5	Origin Technologies withdrew bid in Mar. 2016 after Affymetrix board recommended a lower bid from Thermo Fisher Scientific Inc., citing concerns over approval from U.S. and Chinese regulators	Health & biotechnology
Zoomlion	Terex	\$3.4	Buyer withdrew bid; deal went to Finnish company Konecranes, May 2016	Construction machinery

Source: Various.<sup>222</sup>

### ***Limited Progress at Eighth Strategic and Economic Dialogue***

At the eighth and final round of the Strategic and Economic Dialogue (S&ED) talks under the Obama Administration, held in Beijing on June 6–7, 2016, participants failed to achieve any major breakthroughs on fundamental strategic and economic issues, but left with some deliverables on financial sector and environmental cooperation. (For more information on the outcomes of the strategic track of the S&ED, see Chapter 2, Section 1, “Year in Review: Security and Foreign Affairs.”) On the economic side, overcapacity topped the U.S. agenda, replacing currency valuation as the top concern. The lack of improvements to the investment climate for U.S. com-

panies in China, along with China's recently passed law restricting foreign NGOs,\* added friction to the talks.<sup>223</sup>

The S&ED has been touted as a valuable high-level forum for the United States and China to communicate policy decisions, find common ground, and prevent misunderstandings.<sup>224</sup> Although S&EDs have rarely produced major deliverables, outcomes from this year's talks were modest, with a number of the announcements merely restatements of previous commitments. The limited outcomes of the 2016 S&ED include:

- *Addressing excess production capacity:* China pledged to ensure that its central government policies and support do not “target the net expansion” of its steel capacity, but did not make similar assurances for other key industrial sectors or for local government policies.<sup>225</sup> China also promised to “wind down consistently loss-making ‘zombie enterprises’ through a range of efforts, including bankruptcy and liquidation.”<sup>226</sup> (For more on the measures China said it would undertake to address overcapacity, see Chapter 1, Section 2, “State-Owned Enterprises, Overcapacity, and China’s Market Economy Status.”)
- *Exchange rate reform:* China repeated its pledge to “continue market-oriented exchange rate reform that allows for two-way flexibility and to refrain from competitive devaluation.”<sup>227</sup> China stressed that “there is no basis for sustained depreciation of the RMB,” which investors fear could amplify global financial instability, as happened in January 2016.<sup>228</sup> In turn, U.S. Treasury Secretary Jack Lew acknowledged moves by the PBOC to make the RMB exchange rate more market-oriented: “We were pleased to see reforms made last year and the recognition of that progress in the IMF decision to include the renminbi in the SDR basket.”<sup>229</sup>
- *Expanding RMB trading and clearing capacity in the United States:* China announced it will allow U.S. investors to directly access China’s financial markets through an RMB Qualified Foreign Institutional Investors (RQFII) quota of \$37 billion (RMB 250 billion), the second-largest quota China has granted after Hong Kong.<sup>230</sup> The RQFII program allows approved foreign fund managers to use RMB raised outside China to invest in the country’s financial markets. China also agreed to allow certain U.S. financial institutions to act as clearing houses for settling RMB transactions in the future, which can lower transaction costs for U.S. firms doing business in China.<sup>†</sup><sup>231</sup> These new measures advance Beijing’s goals of internationalizing the RMB and attracting more capital inflows while giving U.S. investors greater access to China’s tightly regulated financial markets.<sup>232</sup>

\*There was significant high-level engagement on China’s new foreign NGO law at the S&ED, with both Secretary of State John Kerry and Treasury Secretary Jack Lew raising U.S. concerns over the law. In his opening remarks at the S&ED, Secretary Lew said, “We are very concerned that China’s recently passed Foreign NGO Management Law will weaken [China’s integration with the global economy] by creating an unwelcome environment for foreign NGOs. President Obama and President Xi have discussed this issue, and addressing it will be important for our bilateral relationship.” U.S. Department of the Treasury, “Remarks by Treasury Secretary Lew at the 2016 U.S.-China Strategic and Economic Dialogue Joint Opening Session,” June 6, 2016.

†In September 2016, the PBOC named Bank of China’s New York branch as the first RMB clearing house in the United States. Bloomberg, “PBOC Appoints Bank of China as First Yuan Clearing Bank in U.S.,” September 20, 2016.

- *Accelerating Bilateral Investment Treaty (BIT) negotiations:*\* The United States and China agreed to submit revised negative list offers in mid-June, after both countries missed a March 2016 deadline for exchanging offers. Both sides agreed to accelerate negotiations, but did not set a deadline for concluding BIT negotiations.<sup>233</sup> After both sides exchanged new offers, U.S. Trade Representative Michael Froman said China’s latest offer “[showed] a serious effort on their part” but remained “a fair distance away from being acceptable.”<sup>234</sup>
- *Enhanced cooperation on climate change and environment:* The United States and China strengthened their cooperation on climate change and environmental protection, which comprised nearly half of the listed strategic outcomes; however, most of the outcomes highlighted existing exchanges and agreements.<sup>235</sup> For instance, the two countries committed to working toward full implementation of the Paris Agreement.<sup>†</sup><sup>236</sup> The listed outcomes also enumerated multiple collaborative projects under the Climate Change Working Group, including initiatives on smart grids, heavy-duty vehicles, and building and industry efficiency.<sup>237</sup>

### **U.S.-China Bilateral Investment Treaty Negotiations**

A recent report prepared by Commission staff analyzes the costs and benefits of the U.S.-China Bilateral Investment Treaty (BIT) and concludes that while a U.S.-China BIT “could potentially unlock sizable benefits, there are a number of potential concerns derived from China’s recent BIT practice that policymakers should weigh when considering the treaty.”<sup>238</sup> For the United States, the BIT presents an opportunity to address and ban Chinese investment practices that are out of line with international investment and legal standards, including unclear regulatory and legal enforcement, forced technology transfer, preferential policies for SOEs, and long-standing market access barriers.<sup>239</sup> For China, the BIT could secure a more politically stable operating environment for Chinese companies in the United States and also serve to facilitate domestic reform of its investment framework by imposing external obligations.<sup>240</sup> However, given China’s history of noncompliance with its World Trade Organization (WTO) obligations, critics of the BIT worry that even a high-standard U.S.-China BIT may not be meaningfully enforceable because it conflicts with Beijing’s stated development path.<sup>241</sup>

To date, the United States and China have exchanged negative list offers four times, mostly recently in September 2016.<sup>242</sup> According to David Dollar, senior fellow at the Brookings Institution (and formerly the Treasury attaché to China), “China has been slow to produce a credible offer on the BIT because enterprises and ministries with vested interests have opposed to opening up

\*For background on U.S.-China BIT negotiations, see Lauren Gloudeman and Nargiza Salidjanova, “Policy Considerations for Negotiating a U.S.-China Bilateral Investment Treaty,” *U.S.-China Economic and Security Review Commission*, August 1, 2016.

†For more information on China’s commitments at the Paris Climate Conference, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, January 6, 2016.

**U.S.-China Bilateral Investment Treaty Negotiations—  
Continued**

and the leadership is apparently not willing to take them on.”<sup>243</sup> U.S. Treasury Secretary Jack Lew has said China’s willingness “to engage in serious negotiations on a high-quality U.S.-China BIT will be [an] important barometer” of whether it views foreign companies as a partner in its economic development.<sup>244</sup>

***Hangzhou G20 Summit***

On September 4–5, 2016, China hosted the 11th G20 Summit, an annual meeting of leaders from the 20 largest economies, in Hangzhou.\* Beijing viewed its first time chairing the G20 Summit as a high-profile opportunity to showcase China’s leadership on the world stage and promote its vision for the global economy.<sup>245</sup> The G20 Summit’s final communique was a broad consensus document organized around five themes: policy coordination, innovation-driven growth, economic and financial governance, trade and investment, and sustainable development.<sup>246</sup> While the communique covered a wide range of issues, its decisions were mainly incremental and lacked concrete and measurable actions.<sup>247</sup> Key issues addressed in the final communique include:

- *Maintaining global economic growth and open trade:* G20 leaders called on countries to use all policy tools—monetary, financial, and structural—to generate greater global growth. They also adopted action plans on innovation and the “new industrial revolution,” two areas expected to provide the basis for future growth.<sup>248</sup> G20 leaders defended open trade, reaffirming their “opposition to protectionism on trade and investment in all its forms.”<sup>249</sup> They also adopted the Guiding Principles for Global Investment Policymaking, laying out basic principles for how countries should treat foreign direct investment.<sup>250</sup>
- *Creating the foundation for an international tax system:* In an effort to address tax evasion and improve transparency, G20 countries and OECD members developed the Inclusive Framework on Base Erosion and Profit Shifting (BEPS), a package of measures governments can implement to close gaps in tax rules. G20 leaders called for the implementation of the BEPS package and endorsed a proposal to identify countries that fail to meet specified criteria for tax transparency. They noted “defensive measures will be considered against listed jurisdictions.”<sup>251</sup>
- *Resolving global excess capacity in industrial sectors:* G20 leaders recognized that excess capacity in steel and other industries is a global issue that requires a collective response. The G20 agreed to set up an OECD-facilitated global forum on steel ex-

\*The Group of Twenty (G20) is an international forum for governments and central banks from 20 major countries to meet and discuss international financial stability issues. Members include Argentina, Australia, Brazil, Canada, China, the EU, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, and the United States. International organizations such as the Financial Stability Board, International Labor Organization, IMF, OECD, UN, World Bank, and WTO also participate. G20 2016 China, “About G20,” November 2015.

cess capacity, which will share information and produce a progress report in 2017.<sup>252</sup>

- *Reforming governance arrangements at the IMF and World Bank:* G20 leaders called for a new IMF quota formula—to be developed before the 2017 Annual Meetings—to reflect increased shares for emerging and developing countries “in line with their relative positions in the world economy.”<sup>253</sup> Similarly, the statement called for the World Bank to implement its shareholding review “with the objective of achieving equitable voting power over time.”<sup>254</sup>

On September 3, ahead of the G20 Summit, President Barack Obama met with President Xi. The top outcome was the announcement that the United States and China formally joined the 2015 Paris Agreement on Climate Change, putting the agreement within reach of entering into force this year.\*<sup>255</sup> On cybersecurity, the two countries reaffirmed their commitment to fully implement the September 2015 cyber commitments, including not conducting cyber-enabled theft of intellectual property for commercial gain.<sup>256</sup> On counternarcotics, China agreed to target exports of substances controlled in the United States even if they are not controlled in China.<sup>257</sup> Flows of precursor chemicals from China to the United States are a persistent problem.

#### **Methamphetamine Precursor Chemicals from China**

A recent report prepared by Commission staff analyzes the scope of methamphetamine (meth) precursor chemical flows from China and their implications for the United States.<sup>258</sup> While Mexican cartels produce the majority of meth used in the United States, around 80 percent of precursor chemicals used in Mexican meth come from China.<sup>259</sup> China is home to the world’s second-largest pharmaceutical industry by revenue, producing and exporting vast quantities of generic drugs and active pharmaceutical ingredients used to manufacture legal and illegal drug products.<sup>260</sup> In addition, Chinese non-pharmaceutical chemical companies ship more than one-third of the world’s chemicals, making it the world’s largest chemical producer and exporter.<sup>261</sup> According to the U.S. Department of State’s estimates, China has more than 160,000 precursor chemical companies and production facilities operating nationwide.<sup>262</sup> The Commission report finds Chinese manufacturers of meth precursors have thrived due to weak regulations and poor oversight over the country’s chemical and pharmaceutical industries.<sup>263</sup> As a result, flows of meth precursors and other dangerous synthetic drugs from China into the Western Hemisphere continue to increase, contributing to a growing drug problem in the United States.<sup>264</sup>

\*The Paris Agreement enters into force when 55 countries representing at least 55 percent of global emissions finalize their domestic processes for joining the agreement; together, China and the United States account for about 40 percent of the world’s carbon dioxide emissions. On October 5, 2016, the United Nations announced the agreement would enter into force on November 4, 2016. United Nations, “Paris Climate Agreement To Enter into Force on 4 November,” October 5, 2016; Eliza Northrop and Melisa Krnjajic, “US and China Join Paris Agreement, Bringing It Much Closer to Taking Effect,” *World Resources Institute*, September 3, 2016; and Alicia Parlapiano, “Climate Goals Pledged by China and the U.S.,” *New York Times*, October 2, 2015.

### United States and China at the WTO

In 2016, tensions between the United States and China heightened over trade, much of which has played out at the WTO. December 2016 marks 15 years since China acceded to the WTO. Beijing contends its accession agreement guarantees it market economy status at the end of 2016, but the United States and the EU dispute this assertion. Gaining market economy status would make it harder for China's trading partners to restore fair market conditions through the imposition of antidumping (AD) duties on its goods. China still falls short of key U.S. criteria for market economy treatment.<sup>265</sup> (For more on the debates and developments on China's market economy status, see Chapter 1, Section 2, "State-Owned Enterprises, Overcapacity, and China's Market Economy Status.")

The United States continues to urge China to report its subsidies to the WTO.<sup>266</sup> Although China agreed to do so when it acceded to the WTO in 2001, China's subsidy notifications are irregular and "significantly incomplete."<sup>267</sup> In their 2016 *Subsidies Enforcement Annual Report to the Congress*, the USTR and the U.S. Department of Commerce noted that China's three subsidy notifications to date\* "exclude numerous central government subsidies for certain sectors (e.g., steel, wild capture fisheries, aluminum), and none of the three included a single subsidy administered by provincial or local government authorities."<sup>268</sup> China's poor record of compliance with WTO transparency obligations makes it difficult to evaluate the nature and extent of its subsidy programs and their trade effects.<sup>269</sup> In response to China's failure to carry out its obligations, the United States conducted its own research and analysis and filed "counter notifications" of Chinese subsidy measures with the WTO. According to the USTR and U.S. Department of Commerce report, "To date, China has not provided a complete, substantive response to these counter notifications" and refuses to discuss this matter with the United States, instead claiming the United States has "misunderstood" China's subsidy programs.<sup>270</sup>

Over the last year, the United States brought WTO cases against China over its agricultural subsidies, export restrictions on raw materials, and aircraft taxation. The United States also requested consultations over alleged Chinese noncompliance with an earlier WTO ruling faulting Chinese AD duties on U.S. broiler chicken products. China challenged the United States' compliance with a WTO ruling that faulted U.S. methodology in determining countervailing duties (CVDs) on certain Chinese products.† Key developments in U.S.-China engagement at the WTO are discussed in the following subsections. New and pending WTO cases between the United States and China are summarized in Addendum I.

\*China filed its first subsidy notification in 2006, five years after joining the WTO; the notification covered 2001–2004. China's second subsidy notification, filed in 2011, covered 2005–2008. China submitted its most recent notification in 2015, covering 2009–2014. Office of the U.S. Trade Representative and the U.S. Department of Commerce, *Subsidies Enforcement Annual Report to the Congress*, February 2016, 13.

†The products are solar panels, pressure pipes, steel line pipes, oil country tubular goods, lawn groomers, kitchen shelving, steel wire, coated paper, aluminum extrusions, steel cylinders, thermal paper, and citric acid. *Inside U.S. Trade*, "China Ramps Up WTO Fight with U.S. over Methodology in CVD Cases," May 19, 2016.

### ***United States Challenges Chinese Agricultural Subsidies***

On September 13, 2016, the United States brought a trade complaint against China at the WTO regarding “excessive” government support provided for rice, wheat, and corn production.<sup>271</sup> According to the USTR’s analysis, the value of China’s price support for rice, wheat, and corn last year was nearly \$100 billion in excess of its commitments under the WTO Agreement on Agriculture.<sup>272</sup> Through its “market price support” programs, China annually sets minimum prices at which the government purchases rice, wheat, and corn in major producing provinces during the harvest season.<sup>273</sup> The USTR alleged that since 2012, China has maintained domestic prices at levels “substantially” above its WTO commitment to cap levels of domestic support at 8.5 percent of the value of production.<sup>274</sup>

China’s use of agricultural subsidies influences domestic production decisions and hurts the ability of U.S. agricultural producers to compete in China and around the world.<sup>275</sup> The United States is the world’s largest agricultural producer. In 2015, China was the United States’ second-largest agricultural export market, with U.S. agricultural exports to China totaling over \$20 billion.<sup>276</sup> The USTR estimates U.S. rice, wheat, and corn exports contribute an additional \$70 billion to the U.S. economy annually and support 200,000 U.S. jobs.<sup>277</sup>

### ***United States Challenges Chinese Export Restrictions on Raw Materials***

On July 13, 2016, the United States launched a trade enforcement action against China at the WTO regarding its use of export duties on nine raw materials.<sup>278</sup> In the request for consultations, USTR officials said the duties, which range from 5 percent to 20 percent, impose on U.S. manufacturers production costs Chinese manufacturers do not have to pay, encouraging companies to locate production operations in China.<sup>279</sup> The nine raw materials—antimony, cobalt, copper, graphite, lead, magnesia, talc, tantalum, and tin—are key inputs for high-value products in important sectors for the U.S. economy, including aerospace, automotive, electronics, and chemicals.<sup>280</sup> The USTR said the export duties are inconsistent with provisions of China’s WTO accession protocol, where it committed to eliminate export duties for all products unless specified in the protocol’s annex; the raw materials named in the case are not included in the annex of exceptions.<sup>281</sup>

On July 19, the United States and the EU filed a joint WTO challenge over China’s export restrictions on raw materials, broadening the United States’ July 13 request for consultations.<sup>282</sup> The new request added chromium and indium to the original list of raw materials subject to export duties and challenged China’s quotas on exports of antimony, indium, magnesia, talc, and tin.<sup>283</sup> China’s MOFCOM defended the restrictions, noting, “They are part of comprehensive measures to strengthen the protection of the ecological environment and are in line with WTO rules.”<sup>284</sup> The U.S. and EU challenge marks the third time the United States and the EU have taken China to the WTO over export restrictions on raw materials.<sup>285</sup> The previous cases, filed in 2012 and 2014, involved rare earths and other raw materials such as bauxite and zinc. In both

cases, the WTO ruled that China's export duties were inconsistent with its accession protocol, and rejected China's defense that its export restraints protected the environment.\*<sup>286</sup>

***United States Alleges Chinese Noncompliance in a WTO Case on Chicken Broiler Product Duties***

In May 2016, the USTR requested a second round of consultations with China at the WTO, alleging China's noncompliance with a 2013 WTO decision faulting Chinese duties on U.S. chicken broiler<sup>†</sup> products.<sup>287</sup> The United States initiated the case in 2011, alleging China was imposing illegal duties on exports of U.S. poultry.<sup>‡</sup> In August 2013, the WTO dispute settlement panel sided with the United States in the majority of the claims.<sup>288</sup> According to the ruling, MOFCOM significantly overestimated U.S. subsidization amounts, which led to excessive imposition of CVDs.<sup>289</sup> It also refused to use records of major U.S. poultry producers, and incorrectly calculated dumping margins and "all others"<sup>§</sup> dumping margins by relying on weight-based methods.<sup>¶</sup><sup>290</sup> The United States and China agreed upon July 9, 2014, as the final date for China to rescind excessive duties. On that date, however, China asserted that U.S. broiler product exports continued to adversely affect China's domestic poultry industry, and adjusted AD duties and CVDs with either slight declines or increases.<sup>291</sup> In August 2016, MOFCOM announced it would extend antisubsidy duties on U.S. broiler chicken imports for a further five years.<sup>292</sup>

***China Alleges U.S. Noncompliance in a WTO Case on Countervailing Duties***

In May 2016, China's MOFCOM initiated dispute settlement proceedings against the United States for noncompliance with the WTO's January 2015 ruling on the U.S. methodology for determining CVDs on certain Chinese-made products.\*\* This case is one of the most far-reaching and complex WTO disputes because China is challenging the technical and legal basis of the U.S. Department of Commerce's methodology across different sectors and numerous products.<sup>293</sup> China alleges the United States has failed to "achieve full, final, and effective compliance with the recommendations and

\*For example, in the raw materials case, the panel report stated, "The difficulty with China's contention is that export restrictions generally do not internalize the social environmental costs of EPRs' [energy-intensive, highly polluting, resource-based products] production in the domestic economy. This is because export restrictions reduce the domestic price of EPRs and therefore they stimulate, instead of reduce, further consumption of polluting EPR products." World Trade Organization, *China – Measures Related to the Exportation of Various Raw Materials*, Dispute DS394, July 5, 2011, 163.

<sup>†</sup>Broiler products include most chicken products, except for live chickens and a few other products such as cooked and canned chicken. U.S. Department of Agriculture, *United States Wins Trade Enforcement Case for American Farmers, Proves Export-Blocking Chinese Duties Unjustified under WTO Rules*, August 1, 2013.

<sup>‡</sup>For the history of China's unfair treatment of U.S. poultry exports, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, June 3, 2016.

<sup>§</sup>The "all others" rate falls upon companies that neither received company-specific rates nor were individually investigated. This rate is calculated by weight averaging all company-specific rates.

<sup>¶</sup>Dumping margins are found by comparing sales of comparable merchandise within a certain timeframe. Weight-based methods refer to taking a specific chicken product's (e.g., breast, leg quarters, paws) weight over the entire chicken's weight.

\*\*For full text of the consultation request, see World Trade Organization, *United States – Countervailing Duty Measures on Certain Products from China*, May 13, 2016.

rulings of the DSB [Dispute Settlement Body].”\* The U.S. Department of Commerce failed to finalize CVDs on four of the 15 cases within the required implementation period.<sup>294</sup> The Chinese government further claims that eight U.S. CVD investigations and determinations continue to use a flawed methodology.<sup>295</sup>

This case takes place against a backdrop of escalating trade tensions. While the U.S. government has the authority to initiate action, every recent AD/CVD case initiated was done so based on petitions filed by private parties.<sup>296</sup> The United States now initiates more AD and other trade defense cases than any other WTO member.<sup>297</sup> In the 2015 fiscal year, the U.S. government initiated 62 investigations, the largest number of investigations in 14 years.<sup>298</sup> China was involved in over half of those cases.<sup>299</sup> In 2016, the number of cases is expected to exceed those in 2015.<sup>300</sup> Of the 48 investigations initiated in first nine months of 2016, China is involved in 28.<sup>301</sup> (For a list of AD/CVD investigations involving China initiated by the United States in 2016, see Chapter 1, Section 2, “State-Owned Enterprises, Overcapacity, and China’s Market Economy Status.”) In turn, Chinese officials seek to challenge U.S. AD duties at the WTO in an effort to protect China’s domestic industries, particularly the strategically and economically important steel industry.<sup>302</sup>

### ***China Ends “Demonstration Bases” Export Subsidy Program after U.S. Challenge***

In April 2016, China agreed to end one of its export subsidy programs in a MOU with the United States; this MOU comes a year after the United States challenged the practice for violating WTO rules.<sup>303</sup> The program in question provided around \$1 billion in central and sub-central government subsidies to seven sectors: textiles, light industry products, specialty chemicals, medical products, hardware materials, agriculture, and advanced materials and metals (including specialty steel and aluminum products).<sup>304</sup> The subsidies were provided through China’s “Demonstration Bases” program, which supported exporters in 179 industrial clusters across the country.<sup>305</sup> Under the program, the Chinese government provided enterprises with subsidies contingent on meeting certain export targets. Some subsidies took the form of cash grants, while other subsidies took the form of free or discounted services provided by designated suppliers known as “common service platforms.”†<sup>306</sup>

\*In the original dispute, China claimed the U.S. Department of Commerce’s methodology and determination of 17 CVD investigations from 2007 to 2012 violated the WTO’s Agreement on Subsidies and Countervailing Duties. The WTO’s Appellate Body found the U.S. Department of Commerce cannot presume that all majority government-owned entities are “public bodies” capable of providing subsidies, and that it must conduct “necessary market analysis” in 15 of the 17 cases to include the consideration of in-country prices as benchmark prices in its CVD investigations and calculations. Previously, the U.S. Department of Commerce calculated the duty using third-country proxies without consulting in-country or private prices in China. In April 2015, the U.S. Department of Commerce initiated compliance proceedings on the 15 CVD investigations faulted by the WTO but failed to finalize CVDs on solar panels, pressure pipes, steel line pipes, and oil country tubular goods within the required implementation period. World Trade Organization, *United States—Countervailing Duty Measures on Certain Products from China*, Dispute DS437, January 16, 2015; *Inside U.S. Trade*, “China Ramps up WTO Fight with U.S. over Methodology in CVD Cases,” May 19, 2016; and U.S. Department of Commerce, International Trade Administration, *Notice of Commencement of Compliance Proceedings Pursuant to Section 129 of the Uruguay Round Agreements Act*, April 27, 2015.

†While the total amount of subsidies provided under the program is unknown, the United States estimates the Chinese government provided certain enterprises with “at least \$635,000

As a result, products from demonstration bases were cheaper and more competitive in export markets.<sup>307</sup> In 2012, for example, 16 demonstration bases in the textile sector accounted for 14 percent of China's total textile exports.<sup>308</sup>

The subsidy program was discovered as part of a separate WTO dispute the United States raised with China in 2012 regarding unfair auto parts subsidies.<sup>309</sup> While China eliminated the auto parts subsidy program, the investigation revealed the network of demonstration bases and illegal export subsidies.<sup>310</sup> The United States challenged the program at the WTO in February 2015, citing concerns that "China's actions [were] damaging [the] international marketplace, undercutting American businesses, and hurting workers in communities across [the] country."<sup>311</sup>

For some U.S. industries, however, the MOU may not be comprehensive enough to maintain free and fair trade in international markets. The steel industry, for example, remains wary of the Chinese government's claims, anticipating Chinese steel companies will receive additional forms of support—like cheap loans from state banks, artificially low prices for inputs such as energy and water, and support for R&D and technology acquisitions—that continue to put U.S. firms at a disadvantage.<sup>312</sup>

### ***United States Challenges China's Discriminatory Taxation for Small Aircraft***

In December 2015, the USTR initiated dispute settlement proceedings at the WTO over China's discriminatory tax exemptions for domestically produced small aircraft. These measures impose a 17 percent value-added tax on imported aircraft while exempting domestically produced aircraft, particularly aircraft under 25 metric tons by weight, in violation of the WTO's nondiscriminatory taxation rules.<sup>313</sup> Examples of exempted aircraft include China's domestically produced regional jet, the ARJ21, and general aviation aircraft ranging from propeller-driven aircraft to business jets.<sup>314</sup> The USTR noted these tax measures were not reported to the WTO as required.<sup>315</sup> (For a discussion of China's industrial policies in the aviation manufacturing industry, see Chapter 1, Section 3, "13th Five-Year Plan.")

The USTR noted that unfair taxation policies disadvantage the U.S. general aviation manufacturing industry, which provides approximately 103,000 jobs and contributes \$14 billion annually to the U.S. economy.<sup>316</sup> According to Ambassador Froman, "China's discriminatory, unfair tax policy is harmful to American workers and American businesses of all sizes in the critical aviation industry, from parts suppliers to manufacturers of small and medium-sized aircraft."<sup>317</sup> Since 2011, U.S. exports of civilian aircraft, engines, equipment, and parts to China more than doubled—reaching \$13.9 billion in 2014, or about 12 percent of total U.S. exports.<sup>318</sup> Based on Chinese regulators' estimates, China's general aviation sector is expected to grow 19 percent annually through 2020, creating enormous potential opportunities for U.S. firms.<sup>319</sup>

worth of benefits annually" and provided "common service platform" suppliers with "almost \$1 billion over a three-year period." Office of the U.S. Trade Representative, *United States Launches Challenge to Extensive Chinese Export Subsidy Program*, February 2015.

## Conclusions

- In 2015, the U.S. goods trade deficit with China increased by 6.5 percent year-on-year to \$367.2 billion, a new record. Over the same period, the U.S. deficit with China in advanced technology products reached \$120.7 billion, a decrease of \$3 billion from 2014. In the first eight months of 2016, the U.S. goods deficit with China fell 5.7 percent year-on-year to \$225.2 billion due to weaker imports. The United States has a substantial but much smaller trade surplus with China in services: in 2015, the U.S. trade surplus in services with China totaled \$29.5 billion. China continues to stall on liberalizing key sectors in which the United States is competitive globally, such as services.
- The Chinese government has made “supply-side structural reform” the dominant theme of economic policy. This concept includes cutting excess industrial capacity and housing inventories, deleveraging, and reducing business costs. Early signs suggest the central government’s supply-side focus has not yet translated into a serious change of course. Facing a slowdown in growth, Chinese policymakers have leaned on stimulus measures to boost growth. Government stimulus has largely accrued to the state sector while the private sector struggles to secure credit, endangering China’s rebalancing.
- China’s rapidly rising debt levels heighten risks to the stability of the country’s financial markets, which can quickly spill over into global markets. Beijing continues to increase the flexibility of its exchange rate, driven in part by its goal of internationalizing the renminbi (RMB). Despite this progress, the People’s Bank of China still carefully manages the value of the RMB, intervening in foreign exchange markets to keep the currency’s external value stable.
- China’s foreign investment climate continues to worsen for companies in strategic industries because of the Xi Administration’s focus on domestic industrial innovation goals. In addition, Beijing has forcefully argued that the country must reduce its dependence on foreign technology due to national security concerns, and introduced stricter information and communications technology requirements and stronger cybersecurity policies.
- While Chinese investment remains a small percentage of total inward foreign direct investment in the United States, it is rising rapidly and will continue to rise, driven by the Chinese government’s “going out” strategy, capital flight, and a generally more open policy environment for outbound investment. Chinese companies’ record acquisition of U.S. assets—in particular, their drive to acquire U.S. technology firms—has led to growing political concern. However, some major Chinese acquisition deals have fallen apart due to regulatory concerns or questions over Chinese buyers’ ability to pay. The Committee on Foreign Investment in the United States (CFIUS) reviews foreign investments in the United States for national security implications. In 2014, the latest year for which data are available, China led foreign countries in CFIUS reviews with 24 reviewed transactions out of more than 100 total

acquisition deals. Although the number of Chinese transactions reviewed increased in absolute terms, it declined as a share of all Chinese acquisitions, and the vast majority of reviewed transactions proceed.

- China appears to be conducting a campaign of commercial espionage against U.S. companies involving a combination of cyber espionage and human infiltration to systematically penetrate the information systems of U.S. companies to steal their intellectual property, devalue them, and acquire them at dramatically reduced prices.
- The U.S. government's efforts to address tensions in the U.S.-China relationship continue to yield only limited results. At the final round of the Strategic and Economic Dialogue talks under the Obama Administration, participants failed to achieve any major breakthroughs but left with some deliverables on financial sector cooperation. Industrial overcapacity topped the U.S. economic agenda, replacing currency as its primary concern, but China only made a vague pledge with regard to steel overcapacity. The unwelcoming investment climate for U.S. companies in China, along with China's recently passed law restricting foreign nongovernmental organizations, also added friction to the talks.
- China's adherence to the World Trade Organization (WTO) principles and its Protocol of Accession remains mixed, partly due to China's opaque subsidy regime. Recently, the United States initiated WTO cases on China's aircraft taxation, export restrictions on raw materials, and agricultural subsidies. The United States also requested consultations over China's continued imposition of antidumping duties on U.S. broiler chicken products, in violation of an earlier WTO ruling.

**Addendum I: WTO Cases**

**Recent and Ongoing WTO Cases Brought by the United States against China**

<b>No.</b>	<b>Title</b>	<b>Request for Consultations</b>	<b>Panel Report</b>	<b>Status</b>
DS427	Antidumping and Countervailing Duty Measures on Broiler Products	September 20, 2011	August 2, 2013	In May 2016, the United States requested a second round of consultations with China over China's alleged noncompliance with a DSB ruling on AD and CVD duties on broiler products from the United States.
DS450	Certain Measures Affecting the Automobile and Automobile-Parts Industries	September 17, 2012	Dispute resolved in consultations stage	China agreed to end its subsidy program for automobile and automobile parts enterprises.
DS489	Subsidies for Demonstration Bases and Common Service Platform Programs	February 11, 2015	Panel established on April 22, 2015; MOU reached April 14, 2016	China agreed to end its demonstration bases export subsidy program in an MOU reached with the United States.
DS501	Tax Measures Concerning Certain Domestically Produced Aircraft	December 8, 2015	In consultations; panel not yet formed	The United States requested consultations with China regarding tax measures in relation to the sale of certain domestically produced aircraft in China.
DS508	Export Duties on Certain Raw Materials	July 13, 2016	In consultations; panel not yet formed	The United States requested consultations with China over China's exports subsidies on nine raw materials.
DS511	Domestic Support for Agricultural Producers	September 13, 2016	In consultations; panel not yet formed	The United States requested consultations with China over China's domestic support for rice, wheat, and corn.

*Source:* World Trade Organization; compiled by Commission staff.

**Recent and Ongoing WTO Cases Brought by China against the United States**

<b>No.</b>	<b>Title</b>	<b>Request for Consultations</b>	<b>Panel Report</b>	<b>Status</b>
DS437	Countervailing Measures	May 25, 2012	July 14, 2014 (Appellate Body Report, December 18, 2014)	The Panel ruled against some of China's claims but also found the United States acted inconsistently with some of its WTO obligations. China appealed the decision, and the Appellate Body reversed several of the Panel's findings against China's claims. In May 2016, China requested consultations over the United States' alleged failure to implement the DSB ruling. A compliance panel was established July 21, 2016; the panel report is expected November 2016.
DS471	Antidumping Methodologies	December 3, 2013	Panel established March 26, 2014	China requested consultations with the United States regarding the use of certain methodologies in AD investigations involving Chinese products.

*Source:* World Trade Organization; compiled by Commission staff.

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