



## U.S.-China Economic and Security Review Commission

Monthly Summary of U.S.-China Trade Data

September 4, 2013

### Highlights of this month's edition

- **Bilateral trade:** Monthly bilateral deficit in goods hits new high; total trade slows; automotive exports the bright spot
- **Bilateral policy issues:** USDA approves processed poultry imports from China; SEC cracks down on J.P. Morgan hiring practices in China; China moves ahead with free trade zone; China allies with BRICs to criticize Federal Reserve policy
- **Sector spotlight:** Aerospace products perform well; U.S. tech companies continue to use China as export platform; new labor report highlights problems of outsourcing to China in electronics and info technology
- **China's economy:** Moderate recovery but imbalances remain; reforms likely at November CPC meeting with focus on financial, fiscal, and urban planning issues; anti-trust actions against foreign firms widen

### U.S.-China Trade Deficit Up, But Growing More Slowly

In July, U.S. Census data registered the highest U.S.-China monthly trade deficit to date, exceeding \$30 billion. Contributing to the spike in the trade deficit was a drop in U.S. exports to China, which hit a twelve-month low. Year-to-date, the U.S.-China trade deficit has reached \$177.8 billion, up just \$3.4 billion from 2012. While exports declined, the value of U.S. imports from China reached the highest level since November 2012, further widening the deficit.

Monthly growth in total trade reached its lowest level since the financial crisis in 2009. Compared to July 2012, growth of imports and exports was down 5.6 and 1.8 percent, respectively. These census figures show that China's economy still relies heavily on demand from U.S. consumers.

*U.S. Monthly Trade Balance with China*  
(US\$ millions)

	Jan	Feb	Mar	Apr	May	June	July
Exports	9,385	9,303	9,435	8,992	8,787	9,182	8,735
Value Imports	37,172	32,715	27,322	33,102	36,646	35,831	38,818
Balance	-27,787	-23,412	-17,886	-24,110	-27,860	-26,650	-30,083

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, September 2013). [http://censtats.census.gov/cgi-bin/naic3\\_6/naicCty.pl](http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl).

### Top Exports and Imports

Although over half of U.S. export sectors to China experienced year-on-year decline in July, transportation equipment exports—the leading U.S. export to China—were up by 115 percent from last year, suggesting resilient demand from China's automotive market. However, the remaining four top exports all dropped from last year. Exports of machinery

saw the largest decline, dropping 19.1 percent year-on-year, followed by chemical exports which declined 11.5 percent.

The value of U.S. apparel and accessory imports from China saw the largest year-on-year growth, up by 36 percent. U.S. exports of apparel and accessory products grew even faster, up 49 percent; however the U.S.-China deficit in apparel and accessory trade remains immense—\$18 billion year-to-date. All of the top-five U.S. imports from China experienced double digit year-on-year growth except for computer and electronics imports. Computer and electronics imports contribute the most to the U.S.-China trade imbalance, with a year-to-date trade deficit that surpassed \$80 billion this month.

*Top Exports and Imports through July 2013*  
(in US\$ millions)

<b>U.S. Top-Five Exports to China</b>				<b>U.S. Top-Five Imports from China</b>			
	Exports	Share of total (%)	Change over Jul'12 (%)		Imports	Share of total (%)	Change over Jul'12 (%)
<i>Monthly (July 2013)</i>				<i>Monthly (July 2013)</i>			
Transportation Equipment	2,159.1	24.7%	114.7%	Computer and Electronic Products	13,458.8	34.7%	2.4%
Computer and Electronic Products	1,388.7	15.9%	-1.8%	Apparel and Accessories	3,659.6	9.4%	36.1%
Chemicals	991.8	11.4%	-11.5%	Miscellaneous Manufactured	3,041.9	7.8%	21.4%
Machinery, Except Electrical	783.8	9.0%	-19.1%	Electrical Equipment, Appliances, and Component	2,924.5	7.5%	18.8%
Waste and Scrap	719.0	8.2%	-0.2%	Leather and Allied Products	2,527.6	6.5%	17.1%
Other	2,692.7	30.8%		Other	13,205.8	34.0%	
<b>Total</b>	<b>8,735.2</b>	<b>100.0%</b>		<b>Total</b>	<b>38,818.4</b>	<b>100.0%</b>	
<i>Year-to-date (thru July 2013)</i>				<i>Year-to-date (thru July 2013)</i>			
Transportation Equipment	12,191.9	19.1%		Computer and Electronic Products	89,833.9	35.6%	
Computer and Electronic Products	9,224.5	14.5%		Electrical Equipment, Appliances, and Component	19,200.7	7.6%	
Chemicals	7,547.7	11.8%		Miscellaneous Manufactured	18,478.0	7.3%	
Agricultural Products	7,003.6	11.0%		Apparel and Accessories	18,009.6	7.1%	
Machinery, Except Electrical	5,831.2	9.1%		Leather and Allied Products	14,904.4	5.9%	
Other	22,018.8	34.5%		Other	92,261.1	36.5%	
<b>Total</b>	<b>63,817.7</b>	<b>100.0%</b>		<b>Total</b>	<b>252,687.7</b>	<b>100.0%</b>	

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, September 2013). [http://censtats.census.gov/cgi-bin/naic3\\_6/naicCty.pl](http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl).

## Bilateral Policy Issues

### ***USDA Approval of Poultry Imports from China Highlights Food Safety Risks***

On August 30, the U.S. Department of Agriculture's Food Safety Inspection Service approved four Chinese poultry processors to begin shipping a limited amount of meat to the United States.<sup>1</sup> Although negotiations for approvals have been continuing, the move came earlier than expected. Experts forecast that it would take until the fall for any breakthroughs.<sup>2</sup>

The approval addresses a perennial sticking point in bilateral agricultural negotiations. In 2007, Congresswoman Rosa DeLauro included an item in the 2008 Farm Bill that barred any

<sup>1</sup> Stephanie Strom, "Chinese Chicken Processors Are Cleared to Ship to U.S.," *New York Times*, August 30, 2013.

<sup>2</sup> "FSIS Expected to Move Forward with Poultry Equivalency Finding in Fall," *Inside U.S.-China Trade*, August 7, 2013.

federal funding for inspections of processed poultry from China. Some argue that the move had other repercussions, such as China's extended and unjustified ban on U.S. beef exports. Moreover, the approval comes just weeks after the World Trade Organization (WTO) found that China's antidumping duties on U.S. broiler chicken exports violated its WTO obligations, opening the door for more U.S. poultry exports to China if the duties are removed later this year. Even with the duties in place, U.S. exports of poultry products reached a record high this year, illustrating the vast potential of China's market, which is shifting to a more protein-based diet and diversifying from pork to poultry and beef.<sup>3</sup>

However, food safety advocates, such as Food and Water Watch, argue that issuing the approval for processed poultry from China simply in order to improve bilateral poultry trade ignores other risks. U.S. food safety inspectors are only able to monitor a small amount of food imports at the U.S. border, and visit only a miniscule number of food processing facilities on the Mainland. Once the USDA approves the poultry processing plants in China, it will have no permanent inspector on site. China has a very poor track record on food safety, especially when compared to Canada, Chile, and Costa Rica, which currently are the only countries permitted to export poultry to the United States. Although the approval will initially be only for birds raised in the United States and Canada, critics argue that it opens the door for future exports of chickens raised in China.

The Food and Drug Administration (FDA), which regulates non-meat food imports into the United States, issued new regulations in August for imported foods. Central to the regulations is the creation of a foreign supplier verification program (FSVP), under which importers in the United States must assess which types of safety risks are posed by the food they are importing and retrieved and maintain documentation from the exporter showing how they are mitigating those risks. For foods that pose higher risks, importers will be required to conduct or obtain results of annual on-site audits of the exporter's facility to ensure that the risks are being adequately addressed. However, a notable loophole in the new regulations is aquaculture, a product group in which China is far more competitive in the U.S. market than is the case for poultry. Aquaculture products remain subject only to the less stringent "HACCP" program, under which importers are not required to retain detailed documentation that shows how foreign suppliers are mitigating risks. Some also argue that the FDA is shifting some of the burden of food safety accountability to importers in the private sector.<sup>4</sup>

### ***SEC Probes JP Morgan's Hiring Practices in China***

On August 17, the *New York Times* reported on a federal bribery investigation into the Hong Kong subsidiary of J.P. Morgan Chase for allegedly hiring the children of Chinese officials in order to facilitate business deals with Chinese companies.<sup>5</sup> The Security and Exchange Commission's (SEC) initial probe focused on two hires over the last five years. Tang Xiaoning, the son of Tang Shuangning, the chairman of China Everbright Group and former Chinese banking regulator, caught the attention of investigators due to a sudden increase in J.P. Morgan's dealings with China Everbright. Records show that after Mr. Tang started working for J.P. Morgan in 2011, the bank won numerous advisory positions with China Everbright, including its clean energy subsidiary, China Everbright International, on a \$162

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<sup>3</sup> "U.S. Poultry Imports on Rise Despite Chinese AD, CVD Duties: Analysis," *Inside U.S.-China Trade*, August 14, 2013.

<sup>4</sup> "FDA Proposes New Requirements for Importers to Show Food Is Safe," *Inside U.S.-China Trade*, August 14, 2013.

<sup>5</sup> Jessica Silver-Greenberg, Ben Protess, and David Barbosa. "Hiring in China by JPMorgan Under Scrutiny," *New York Times*, August 17, 2013. <http://dealbook.nytimes.com/2013/08/17/hiring-in-china-by-jpmorgan-under-scrutiny/>.

million sale of shares in 2012.<sup>6</sup> A second hiring under investigation is Zhang Xixi, the daughter of former senior railway minister, Zhang Shuguang. Near the time of the minister's daughter's hiring in 2007, the China Railway Group, believed to garner most of its business with the Chinese government, hired J.P. Morgan to help prepare its IPO. In 2011, as Ms. Zhang was an associate at the bank, a high speed railway operator of a track from Beijing to Shanghai hired J.P. Morgan in an advisory role before its own public offering.

The case against J.P. Morgan does not stop at the two children of Chinese officials – it has expanded across Asia and involves a "Sons and Daughters" program originally created with the intention to prevent bias in J.P. Morgan's hiring practices. According to Bloomberg, federal investigators found "an internal spreadsheet that linked appointments to specific deals pursued by the bank," which has caused them to look into interns and full-time hires throughout Asia.<sup>7</sup> One of the unintended effects of the "Sons and Daughters" program is that it provided an easier pathway for princelings to a job with the company. Through a separate track created for applicants with government connections, some of the individuals reportedly had less stringent interviews and substandard qualifications.<sup>8</sup>

J.P. Morgan's hires in and of themselves do not implicate the bank with any wrongdoing. The onus is on prosecutors to prove that the individuals were hired for illicit purposes and that J.P. Morgan was doing so to influence a foreign official to obtain contracts. In fact, the practice is widespread among investment banks and drives competition to hire more sons and daughters of prominent figures. However, such systemic hiring clearly illuminates serious oversight problems with the banking sector. This is particularly evident in the prevalence of princelings hires among Hong Kong investment banks. *The Wall Street Journal* reported on September 2 that Merrill Lynch and Goldman Sachs employed princelings to help facilitate two of the largest IPOs in history, the Agricultural Bank of China and the Industrial and Commercial Bank of China (ICBC).<sup>9</sup> The J.P. Morgan probe will further reveal details of the banks' hiring practices in Hong Kong and bring pause to other banks doing business in Mainland China through proven means of hiring princelings to complete lucrative deals.

The case comes as Washington and Beijing both step up efforts to crack down on illicit practices in their respective financial and corporate sectors. Under its new head Mary Schapiro, the SEC has taken a more aggressive stance toward Wall Street. The princelings case follows a string of charges against J.P. Morgan from federal prosecutors this month. The SEC and the Federal Bureau of Investigation (FBI) charged two former London-based J.P. Morgan traders with disguising losses of hundreds of millions of dollars. In addition, J.P. Morgan settled with the Federal Energy Regulatory Commission, the top U.S. energy regulator, for \$410 million after it was charged with manipulating California and Michigan energy markets. More civil and criminal charges may be on the horizon relating to J.P. Morgan's sales of mortgage-backed securities in the lead-up to the financial crisis.<sup>10</sup>

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<sup>6</sup> Jessica Silver-Greenberg and Ben Protess, "JPMorgan Hiring Put China's Elite on an Easy Track," *New York Times*, August 29, 2013. <http://dealbook.nytimes.com/2013/08/29/jpmorgan-hiring-put-chinas-elite-on-an-easy-track/>.

<sup>7</sup> Dawn Kopecki, "JPMorgan Bribe Probe Said to Expand in Asia as Spreadsheet Is Found," *Bloomberg*, August 28, 2013. <http://www.bloomberg.com/news/2013-08-29/jpmorgan-bribe-probe-said-to-expand-in-asia-as-spreadsheet-found.html>.

<sup>8</sup> William Alden, "JPMorgan's 'Sons and Daughters' Program," *New York Times*, August 30, 2013. <http://dealbook.nytimes.com/2013/08/30/morning-agenda-jpmorgans-sons-and-daughters-program/>.

<sup>9</sup> Cynthia Koons, Nisha Gopalan, and Robin Sidel, "Banks' 'Princelings' Hires Were Widespread in China," *Wall Street Journal*, September 2, 2013. <http://online.wsj.com/article/SB10001424127887324202304579050550432355702.html>.

<sup>10</sup> The Editorial Board, "Chasing JPMorgan Chase," *New York Times*, September 1, 2013. <http://www.nytimes.com/2013/09/02/opinion/chasing-jpmorgan-chase.html>.

China has also seen a litany of high-profile anti-graft cases since the new leadership under President Xi Jinping took over in March. The efforts are being led by Wang Qishan, a member of the Standing Committee, the Communist Party's top decision-making body. Wang, formerly with an economic portfolio, was surprisingly appointed to head the Central Disciplinary Commission in order to tackle corruption. In August, the Commission detained and sacked Jiang Jiemin, the head of the State-owned Assets Supervision and Administration Commission (SASAC), a central body charged with administering the country's central state-owned enterprises. Jiang until March of this year had served as the head of China National Petroleum Corp. (CNPC), one of the country's three central state-owned oil companies. In connection with this case, four officials at CNPC and its Hong Kong-listed unit, PetroChina Co., were removed from their posts. Other officials under investigation by the discipline commission include Liu Tienan, vice chairman of the National Development and Reform Commission (NDRC), the country's planning agency, who was fired in May and expelled from the Party in August.<sup>11</sup>

### **China's Free Trade Initiatives**

On August 22, the Ministry of Commerce posted a statement that the establishment of the proposed Shanghai Free Trade Zone (FTZ), which was detailed in the USCC's August Trade Bulletin, has received final approval from the State Council.<sup>12</sup> According to the *South China Morning Post*, the FTZ is set to officially launch on September 27. It was also reported that the current vice-mayor of Shanghai, Ai Baojun, will be named the head of a new commission to oversee the development of the free trade zone.<sup>13</sup>

The FTZ is likely to attract U.S. businesses, particularly from the financial sector. Plans were discussed at the bilateral Strategic and Economic Dialogue meetings in July. For example, financial institutions may be allowed to increase the quantity and sophistication of financial products in the FTZ, providing Chinese firms with new credit channels, such as corporate bonds and bond futures. The FTZ may also allow foreign commodities exchanges to set up their own delivery warehouses, foreign health insurance companies to establish wholly owned operations, and foreign shipping companies to form cargo joint ventures.<sup>14</sup>

The Shanghai government pressed for the creation of the free trade zone following the 2012 establishment of the special trade zone in Qianhai, which allows banks from Hong Kong to offer cross-border RMB-denominated loans to mainland companies. Other large Chinese cities such as Guangzhou, Nansha, Tianjin, Xiamen, and Zhuhai have also expressed interest in establishing FTZs in order to ease capital controls and further open the service sector. The initial approval of the Shanghai FTZ in July has already led to a surge of

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<sup>11</sup> Benjamin Haas and Michael Forsythe, "China Probes State-Assets Head as Anti-Graft Push Widens," *Bloomberg*, September 1, 2013. <http://www.bloomberg.com/news/2013-09-01/china-state-assets-head-jiang-under-investigation-xinhua-says.html>.

<sup>12</sup> Ministry of Commerce of the People's Republic of China, "[State Council Approves Establishment of Shanghai Pilot Free Trade Zone], *Guowuyuan Pizhun Sheli Zhongguo (Shanghai) Ziyou maoyi Shiyangu,*" August 22, 2013. <http://www.mofcom.gov.cn/article/ae/ai/201308/20130800262548.shtml>.

<sup>13</sup> George Chen, "Shanghai Vice Mayor Ai Baojun to Head Up Free-Trade Zone Later This Month," *South China Morning Post*, September 3, 2013. <http://www.scmp.com/news/china/article/1302184/shanghai-vice-mayor-ai-baojun-head-free-trade-zone-later-month>.

<sup>14</sup> George Chen, "Shanghai Plan to Lure Foreign Investors to Free-trade Zone," *South China Morning Post*, July 11, 2013. <http://www.scmp.com/news/china/article/1279855/beijing-plans-lure-foreign-investors-shanghai-free-trade-zone>.

investment in Shanghai-based port operators, logistics companies, and property developers whose business is expected to benefit from the FTZ.<sup>15</sup>

Although regulations have already been loosened in Qianhai, confusion spawned by the lack of details about policies and their implementation has left some investors cautious. Analysts have also warned that excessive investment may lead to a speculative investment bubble, recognizing that is still largely unclear how much they will benefit from the free trade zone.<sup>16</sup> The establishment of the Qianhai special trade zone apparently led to a steep rise in local property prices.<sup>17</sup>

Aside from developments in China's domestic free trade zones, China has been negotiating more comprehensive bilateral and multilateral trade deals. This year China has signed bilateral free trade agreements (FTAs) with Iceland and Switzerland—the FTAs signed between China and European countries. To date, the PRC has signed 13 separate FTAs and is currently in the process of negotiating six additional bilateral and multilateral agreements. In particular, China has been participating in multilateral negotiations with ASEAN members to establish the Regional Comprehensive Economic Partnership (RCEP). The RCEP is an ASEAN-led initiative to link the 10 existing ASEAN member partners (Australia, China, India, Japan, New Zealand, and South Korea) to form the world's largest regional trading bloc. RCEP negotiations began in May 2013 and are poised to conclude by the end of 2015. If concluded, the trading bloc will represent 49 percent of the world's population and account for 30 per cent of world GDP.<sup>18</sup>

The RCEP has been viewed as a move to counteract the United States' high-profile involvement and promotion of the Trans-Pacific Strategic Economic Partnership (TPP) regional trade agreement. China is currently not a participant in the negotiations and has interpreted the Asia-Pacific trade bloc as a strategy to reduce China's economic influence in the region. Moreover, the China-supported RCEP includes multiple countries concurrently participating in the TPP negotiations such as Australia, Japan, and New Zealand, but currently excludes the United States. There is fear that concurrent negotiation of two trade pacts may lead to conflicting regulations and standards and become a point of contention between the United States and China.<sup>19</sup>

In response to the diverging regional trade initiatives between the United States and China, the Peterson Institute for International Economics has begun a study to analyze the economic advantages and disadvantages of a hypothetical U.S.-China free trade agreement. The study will not only look at the effects on the United States and China, but also examine the impacts of a U.S.-China FTA on partner countries included in the TPP and RCEP. The

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<sup>15</sup> Yimou Lee and Michelle Chen, "China's New Economic Zone Fails to Draw HK Property Tycoons," August 16, 2013. <http://www.reuters.com/article/2013/08/16/us-property-china-idUSBRE97F07520130816>.

<sup>16</sup> Jenny Yu, "Analysts warn of free-trade bubble," *South China Morning Post*, September 3, 2013. <http://www.scmp.com/business/money/markets-investing/article/1302119/analysts-warn-free-trade-bubble>

<sup>17</sup> Yimou Lee and Michelle Chen, "China's New Economic Zone Fails to Draw HK Property Tycoons," August 16, 2013. <http://www.reuters.com/article/2013/08/16/us-property-china-idUSBRE97F07520130816>.

<sup>18</sup> Ganeshan Wignaraja, "Why the RCEP Matters for Asia and the World," East Asia Forum, May 15, 2013. <http://www.eastasiaforum.org/2009/05/15/asean6-as-a-step-towards-an-asian-economic-community/>.

<sup>19</sup> Sanchita Basu Das, "RCEP and TPP: Comparisons and Concerns Working," Institute of Southeast Asian Studies, January 7, 2013. [http://www.iseas.edu.sg/documents/publication/ISEAS%20Perspective%202013\\_2.pdf](http://www.iseas.edu.sg/documents/publication/ISEAS%20Perspective%202013_2.pdf).

study is partially funded by the U.S. Chamber of Commerce and is due to be published by the end of the year.<sup>20</sup>

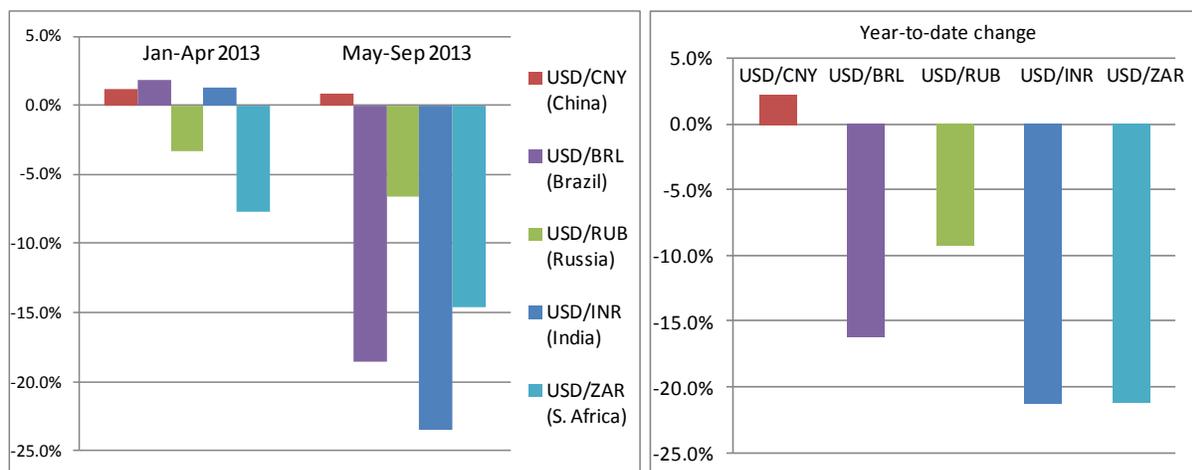
### Exchange Rates and the BRICs

Since May, when the U.S. Federal Reserve first indicated that it may taper its massive quantitative easing program, capital has been flowing out of emerging economies and into increasingly attractive assets in the United States. In turn, currencies of emerging economies have suffered, with most currencies falling 5-15 percent against the dollar.<sup>21</sup> This drop in currencies has been most severe in India, where the rupee lost a fifth of its value in three months.<sup>22</sup> Such volatility makes it difficult for businesses to plan for the future and discourages investment.

In contrast to most emerging economies currencies, China’s currency, the Renminbi (RMB), has fared well. Due to China’s capital controls to prevent capital flight, and a currency trading band that restricts the RMB from moving against the dollar, the value of the RMB has been largely unaffected by the Fed announcement.

Even so, China has joined other countries whose currencies are suffering in advocating that the Fed exercise more caution in its tapering policy.<sup>23</sup> China may be taking these measures because it foresees greater currency liberalization in the near future – China may further widen its daily trading band for the RMB later this year, which would make it more susceptible to Fed policy.

*Change in Value of Emerging Market Currencies (Nominal change)*



Source: Oanda Corporation, "Historical Currency Rates Comparison." <http://www.oanda.com/currency/historical-rates/>.

<sup>20</sup> Inside U.S. Trade, "Peterson Studies Potential Effects Of U.S.-China FTA, Including On SOEs, September 3, 2013. <http://insidetrade.com/201308212444566/WTO-Daily-News/Daily-News/peterson-studies-potential-effects-of-us-china-fta-including-on-soes/menu-id-948.html>.

<sup>21</sup> Bronwen Nortje, "Brics to Look at Ways of Curbing Capital Outflows," *Business Day*, September 2, 2013, via Factiva

<sup>22</sup> Lidia Kelly and Alonso Soto, "BRICS Agree on Bank's Structure, Progress Difficult: Russia," Reuters, September 1, 2013. <http://www.reuters.com/article/2013/09/01/us-brics-bank-idUSBRE9800FB20130901>.

<sup>23</sup> Kevin Yao, "Ahead of G20, China Urges Caution in Fed Policy Tapering," Reuters, August 27, 2013. <http://www.reuters.com/article/2013/08/27/us-china-economy-q-idUSBRE97Q02S20130827>.

The currency issue is likely to be a hot topic at the G-20 meeting in St. Petersburg, Russia, this month. International institutions such as the Organization for Economic Cooperation and Development have also recognized the risks of intensified outflows from emerging economies, warning that it could weaken recovery in global economic growth.<sup>24</sup> There has also been talk by finance ministers of emerging economies to intervene in global currency markets to slow the outflow of funds from emerging markets. Over the past year, BRICS nations (Brazil, Russia, India, China, and South Africa) have been working on a joint proposal to establish a \$100 billion contingency fund to allow them to exercise more control over their currencies. China has agreed to make the largest contribution to the fund.<sup>25</sup>

## Sector Spotlight

### ***Advanced Technology Product (ATP) Trade***

U.S. advanced technology product exports to China were up 23 percent from July, led by a 55 percent increase in aerospace exports. The strong performance in aerospace product exports this year has helped reduce the U.S.-China trade deficit in total advanced technology products by \$558 million from last year. The year-to-date aerospace product trade surplus rose by \$1.7 billion. And yet, these developments have been offset by a \$3.8 billion increase in imports from China in the information and communications sector. U.S. technology firms continue to use China as their primary assembly platform.

*U.S. Trade with China in Advanced Technology Products*  
(US\$ millions)

	Monthly			Cumulative year-to-date			
	Exports	Imports	Balance Jul'13	Exports	Imports	YTD Balance Jul'13	YTD Balance Jul'12
<b>TOTAL</b>	<b>2,728</b>	<b>11,933</b>	<b>-9,205</b>	<b>15,510</b>	<b>78,868</b>	<b>-63,358</b>	<b>-63,916</b>
(01) Biotechnology	28	7	21	235	42	193	116
(02) Life Science	215	169	46	1,673	1,176	497	352
(03) Opto-Electronics	22	481	-459	187	2,567	-2,380	-3,980
(04) Information & Communications	357	10,813	-10,456	2,544	72,018	-69,474	-65,615
(05) Electronics	429	275	154	2,703	1,875	828	514
(06) Flexible Manufacturing	301	86	215	1,639	522	1,117	708
(07) Advanced Materials	15	24	-9	125	135	-10	39
(08) Aerospace	1,355	64	1,291	6,185	451	5,734	3,986
(09) Weapons	0	13	-13	1	78	-77	-75
(10) Nuclear Technology	5	0	5	218	2	216	40

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, September 2013). [http://censtats.census.gov/cgi-bin/naic3\\_6/naicCty.pl](http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl).

### ***The Electronics and Information Technology Sector***

In July, China Labor Watch, a New York-based advocacy group, published one in an ongoing series of reports on labor abuses by foreign companies in China's electronics sector. While past reports have looked at Samsung and other producers, the July report focused on Apple

<sup>24</sup> Paul Hannon and Paulo Trevisani, "Leaders Seek Balm for Emerging Markets at G-20 Summit," Dow Jones News Service, September 3, 2013, via Factiva

<sup>25</sup> Paul Hannon and Paulo Trevisani, "Leaders Seek Balm for Emerging Markets at G-20 Summit," Dow Jones News Service, September 3, 2013, via Factiva

Inc., the U.S. technology giant that accrues high profits from its sales of iPhones, iPads, and MacBooks.<sup>26</sup> Almost all of Apple's products are manufactured in China, the majority by Foxconn (Hon Hai), a contract manufacturer headquartered in Taiwan that has several large assembly plants across China. Foxconn is a strategically important employer for China's migrant laborers, in coastal cities such as Shenzhen and Shanghai, and increasingly, also in inland provinces like Sichuan, Shanxi, and Henan, where labor costs are cheaper. Its factories typically hire tens of thousands of young workers, with a high degree of labor turnover.<sup>27</sup>

Foxconn garnered negative attention in the foreign media and NGO community beginning in 2010, when several suicides were reported at its plant. As recently as last fall, large riots at the Zhengzhou plant disrupted the supplier's shipments of the recently launched iPhone 5. The cause of the riots was viewed by some as the consequence of poor working conditions, such as excessive overtime and mistreatment of workers by guards on site.<sup>28</sup>

In response to complaints about labor conditions, Foxconn allowed Apple to hire a third party, the Fair Labor Association from New York, to audit its plants and suggest improvements to factory conditions. As part of its reforms, Foxconn earlier this year announced that its employees would be allowed to establish an independent union to voice their demands.<sup>29</sup> According to the July report by China Labor Watch, however, Foxconn has not followed through on all of its promises, in particular the pledge to reduce overtime hours, which violate statutes of China's own Labor Law. The report was widely cited in the press, compelling Apple to issue a public response.<sup>30</sup>

As China rebalances its economy, its labor costs are rising, especially in foreign-invested factories. China's official data shows that, while the ratio of manufacturing sector wages, and by extension, wages in foreign-funded enterprises, declined relative to the average wage in China in 2002-2009, the trend has reversed since then.

However, China is likely to remain the assembly site of choice for the world's major electronics companies. Suppliers operate within highly sophisticated supply chains, part of regionally integrated production networks that take years to establish. Components are imported from countries like Korea, Japan, and Taiwan, and assembled in China at very low cost. China's labor pool may be the only one in the world large enough to sustain the rapid turnover rates common at large electronics factories.

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<sup>26</sup> China Labor Watch, "Apple's Unkept Promises: Cheap iPhones Come at High Costs to Chinese Workers," (New York: July 29, 2013).

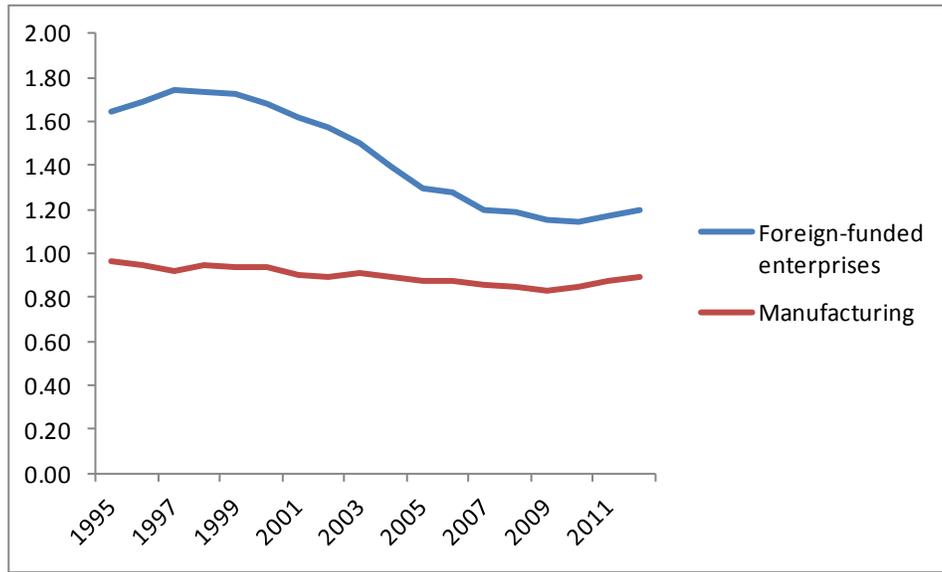
<sup>27</sup> "Foxconn Firm Forecast to Retain Lion's Share of Apple Supply Contracts," *South China Morning Post*, July 9, 2013, via Factiva.

<sup>28</sup> Kathrin Hille and Sarah Mishkin, "Production Halted After Riot," *Financial Times*, September 25, 2012, via Factiva.

<sup>29</sup> "Foxconn's Union Is a Sign that Cheap China Is No More," *Financial Times*, February 7, 2013, via Factiva.

<sup>30</sup> China Labor Watch, "Apple's Unkept Promises: Cheap iPhones Come at High Costs to Chinese Workers," (New York: July 29, 2013).

*Ratio of Foreign-Funded Enterprise and Manufacturing Wages to China's Average Wages*

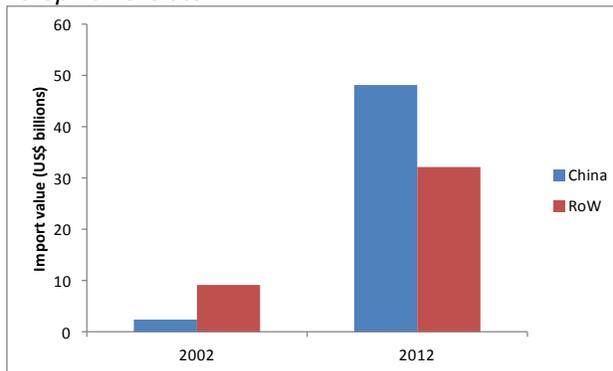


Source: National Bureau of Statistics, via CEIC data.

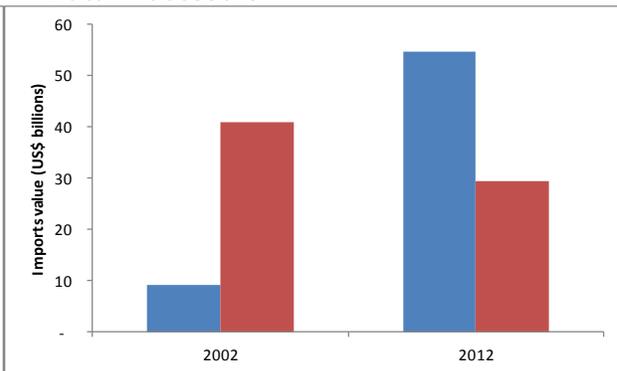
The difficulty of shifting this pattern is apparent in the U.S. trade balance with China – the bulk of China’s “advanced technology products” exports to the United States, as defined by the U.S. Census Bureau, are in the information and communications sector. In 2002, U.S. imports of telephone sets and data processors as a whole was very small, and China accounted for less than half of those imports. By 2012, imports had grown exponentially, and China accounted for over half of the total. In the case of data processors, which include laptops and personal computers, imports from countries other than China actually declined in 2002-12, suggesting a direct displacement of other producers by Chinese rivals.

*U.S. Imports of Telephone Sets and Data Processors, China vs. the Rest of the World*  
US\$ billions

*Telephone Sets*



*Data Processors*



Note: In the HTS code, telephone sets refer to HTS-8517, and data processors refer to HTS-8471.  
Source: U.S. International Trade Commission.

The structural dependence on China makes improving labor conditions a challenging issue for U.S. firms, both economically, and in terms of brand reputation. Some have suggested

that U.S. companies should factor higher labor costs into their cost structure – according to the independent consultancy iSuppli, labor makes up less than 5 percent of the cost of an iPhone. Another option, which may do less to improve factory conditions in China, is to shift some production to cheaper suppliers. Pegatron, one of Foxconn’s up-and-coming rivals, is growing rapidly, and was contracted by Apple earlier this year to produce a new generation of cheaper iPhone models.<sup>31</sup>

## **China’s Economy**

### ***A Moderate Recovery***

After China’s real GDP growth slowed to 7.5 percent in the second quarter of 2013, continuing its steady decline over 10 straight quarters, the third quarter has suggested a moderate recovery. The basis for the upswing has been the export-oriented manufacturing sector, which has been plagued by overcapacity and weak demand. Exports in July rose by 5.1 percent year-on-year, after not expanding in the previous two months. The rebound hinted that external demand is picking up, particularly in the U.S. economy. Foreign direct investment, which is largely channeled into manufacturing, in July grew by 24.1 percent from the previous year. The improvement in China’s external accounts appeared to buoy factory activity. Industrial output rose 9.7 percent year-on-year, the highest since December 2012. Producer prices, which have declined since the beginning of 2012, saw a slight uptick. Industrial firm profits increased by 11.6 percent year-on-year in July, compared to 6.3 percent in June.<sup>32</sup> Electricity, consumed more by industry than households, surged to its highest monthly total in a year.<sup>33</sup>

In a further sign of manufacturing sector recovery, imports rose by 10.9 percent, outpacing exports and reversing two months of decline. Commodities, used as industrial inputs, were the key driver of goods purchases from abroad. The volume of China’s iron ore imports surged to a record high in July, increasing by 26 percent year-on-year, more than double the rate of China’s total goods imports and the highest rate since early 2012. Oil imports were also up 20 percent. Because commodity prices have declined this year, there was an added incentive for China’s producers to purchase raw materials at bargain prices. Due to the outsized impact of China on world commodity markets, its increased purchases immediately “breathed new life” into commodity exchanges.<sup>34</sup>

The latest reading of the purchasing managers’ index (PMI) suggested that the July trends in the economy improved business sentiment in August. An independent PMI measure from HSBC, the Hong Kong bank, hit 50.1, the first expansion in manufacturing since April. China’s official (CFLP) PMI for the manufacturing sector hit a 16-month high, and exceeded median estimates of 50.6 in a Bloomberg News survey of analysts.<sup>35</sup> In a reversal of July PMI data, manufacturers in China were generally more optimistic than in other emerging

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<sup>31</sup> Eva Dou, “Apple Shifts from Foxconn to Pegatron,” *Wall Street Journal*, May 30, 2013; Eva Dou, “Meet the Not-Foxconns,” *Wall Street Journal*, November 16, 2012. <http://blogs.wsj.com/digits/2012/11/16/meet-the-not-foxconns/>.

<sup>32</sup> “Investment Banks Lift China’s Economic Outlook,” Xinhua News Agency, August 27, 2013. [http://www.chinadaily.com.cn/business/2013-08/27/content\\_16924650.htm](http://www.chinadaily.com.cn/business/2013-08/27/content_16924650.htm).

<sup>33</sup> “China’s July Industrial Electricity Use Surges to Most in a Year,” *Bloomberg*, August 14, 2013. <http://www.bloomberg.com/news/2013-08-14/china-s-july-industrial-electricity-use-surges-to-most-in-a-year.html>.

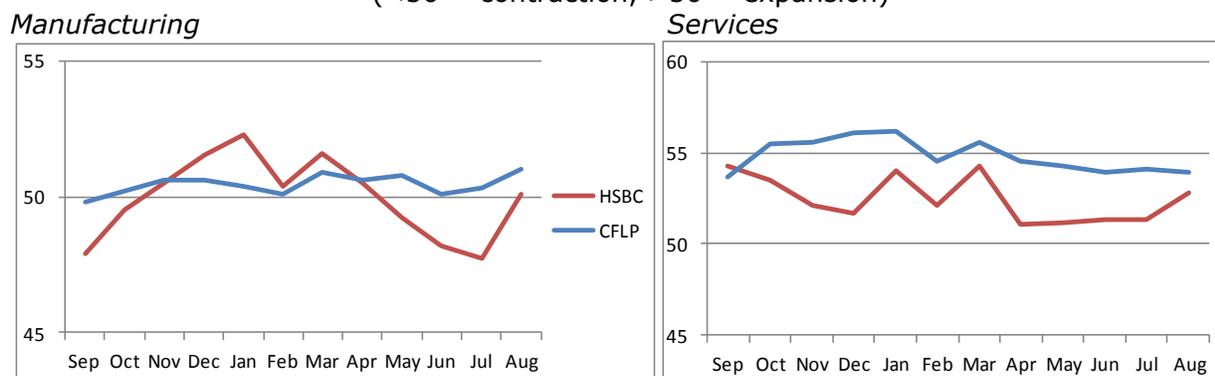
<sup>34</sup> “China Breathes New Life Back into Commodity Markets,” *Wall Street Journal*, August 9, 2013. <http://online.wsj.com/article/SB10001424127887324522504579002291277140378.html>

<sup>35</sup> “China Economy Strengthens as Factory Gauge at 16-Month High,” *Bloomberg*, September 1, 2013. <http://www.bloomberg.com/news/2013-09-01/china-aug-manufacturing-pmi-beats-estimates-with-51-0-reading.html>;

markets, which have suffered a rapid decline in their external accounts and exchange rate values that has affected manufacturing activity. Manufacturing PMI for India in August fell to 48.5 from July's 50.1, its first time in contraction since March 2009. HSBC's manufacturing PMI for Indonesia fell to 48.5 in August from 50.7 in July, a 15-month low and the fourth straight month of decline.<sup>36</sup>

The upswing in manufacturing has, for the time-being at least, allayed concerns of a hard landing for China's economy. A credit squeeze imposed by the People's Bank of China in June compounded sluggish growth by threatening the solvency of banks and enterprises. By August, however, several investment houses revised their GDP forecasts upward. The U.S. bank J.P. Morgan, for example, raised its estimates from 7.4 percent to 7.6 percent for the third quarter and from 7 percent to 7.5 percent for the fourth quarter.<sup>37</sup> A poll of 52 analysts by Bloomberg in mid-August pointed to China maintaining 7.5 percent growth in 2014, in line with Beijing's growth target under the 12<sup>th</sup> Five-Year Plan (2011-15).<sup>38</sup>

*Purchasing Managers' Index Year-to-Date (HSBC vs. CFLP)*  
 (<50 = contraction, >50 = expansion)



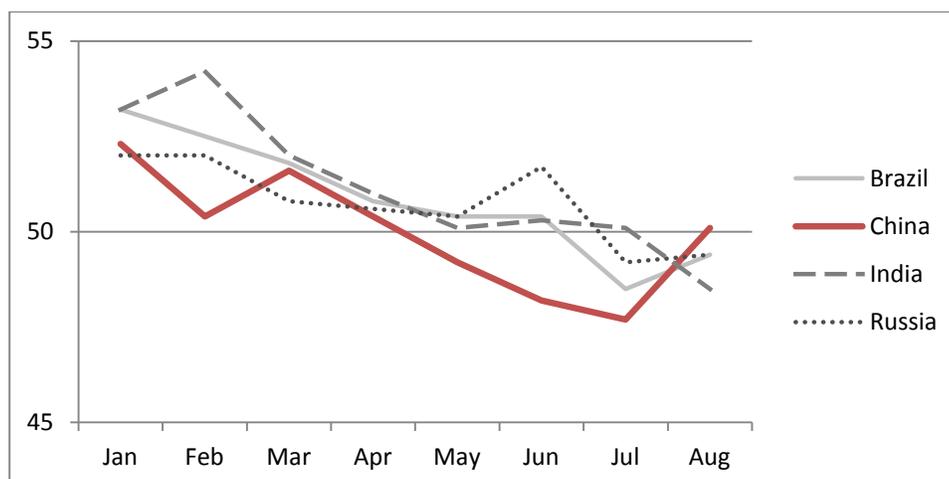
Source: HSBC Purchasing Managers' Index. <http://www.hsbc.com/1/2/emerging-markets/em-index/purchasing-managers-index>; National Bureau of Statistics via CEIC data.

<sup>36</sup> Richard Silk and Michael S. Arnold, "Factory Data from China Is Bright Spot in Asia: Indonesia, India Hit by Selloff in Emerging-Market Assets," *Wall Street Journal*, September 2, 2013. <http://stream.wsj.com/story/economy-stream/SS-2-17745/SS-2-314475/>.

<sup>37</sup> "China Economy Strengthens as Factory Gauge at 16-Month High," *Bloomberg*, September 1, 2013. <http://www.bloomberg.com/news/2013-09-01/china-aug-manufacturing-pmi-beats-estimates-with-51-0-reading.html>;

<sup>38</sup> "China 7.5 Percent Target Seen in Reach as U.S. Demand Picks Up: Economy," *Bloomberg*, August 20, 2013. <http://www.bloomberg.com/news/2013-08-21/china-7-5-target-seen-in-reach-as-u-s-demand-picks-up-economy.html>.

*Purchasing Managers' Index for Manufacturing, BRIC countries, Year-to-Date*  
 (<50 = contraction, >50 = expansion)



Source: HSBC Purchasing Managers' Index. <http://www.hsbc.com/1/2/emerging-markets/em-index/purchasing-managers-index>.

### ***Economic Imbalances Worsen***

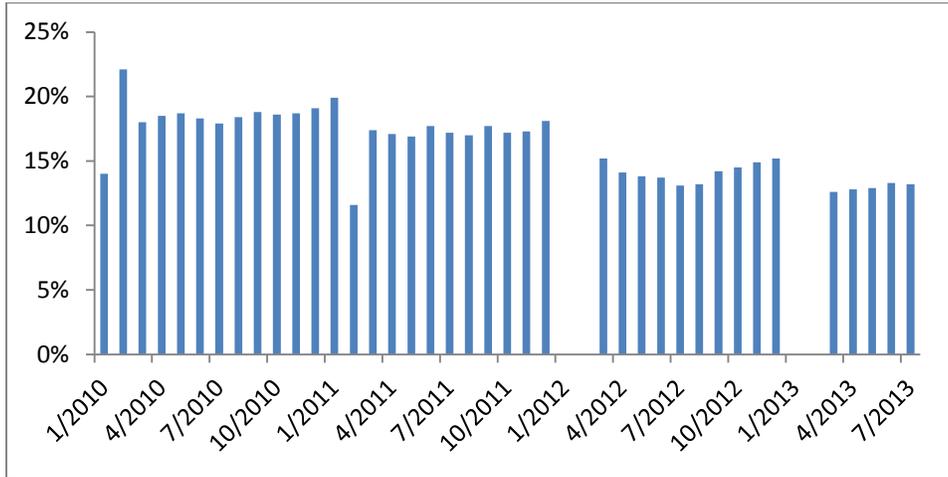
In spite of the recent improvements in the economic outlook, the underlying health of China's economy remains in doubt. Producer sentiment in manufacturing remains weaker than in 2012. Basic indicators, such as exports and industrial output, have improved in the short term, but still lag well behind levels of 2010-11. The recent increase in FDI value disguises the fact that cumulative FDI contracts in 2013 have declined, suggesting that fewer new investors are entering the country.

A more fundamental concern is that, despite Beijing's stated objective to lift the spending power of its citizens and transition towards a consumption-driven economy, the opposite seems to be occurring this year. The most reliable measure for consumption, retail sales, has been anemic all year. That trend may be tied to a lack of income growth. In the first half of 2013, growth in nominal median urban household income took a dive, down 5.8 percentage points from last year. The urban household saving rate remained high, reaching 35.6 percent, up 1.1 percent from 2012—a sign that Chinese in urban areas are holding on to more of their disposable income. There was also a decline in the growth of real urban disposable income, which dropped below GDP growth and marked the slowest growth in real urban disposable income since 2008, only growing 6.5 percent year-on-year.<sup>39</sup>

Recent surveys of producers suggest negative trends in labor markets for the second half of the year. The HSBC services PMI for August showed a decline in employment levels, as well as cuts in payroll numbers that suggested reduced wages. Manufacturing PMI, both official and HSBC, showed declining employment growth in factories as well.

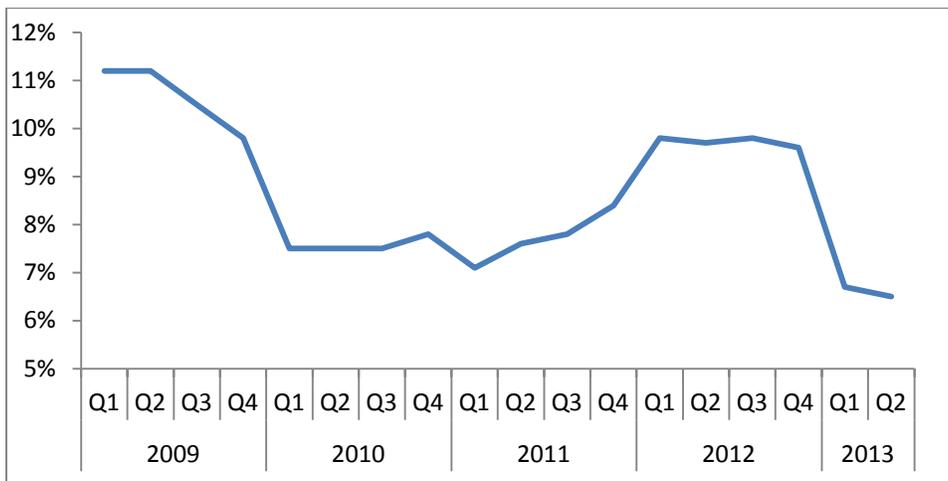
<sup>39</sup> National Bureau of Statistics, via CEIC Database

*Retail Sales Growth in China, through July 2013*  
Monthly, year-on-year (%)



Source: National Bureau of Statistics via CEIC data.

*Growth in Real Urban Household Disposable Income Per Capita*  
Cumulative, year-on-year (%)



Source: National Bureau of Statistics via CEIC data.

Moreover, in spite of the credit squeeze in June, it appears that China's economy is still being driven by over-investment. Fixed asset investment (FAI) has remained stubbornly high at around 20 percent monthly growth throughout the year. Notably, manufacturing, which accounts for around one-third of FAI, has grown more slowly than total FAI this year, for the first time since the financial crisis. That suggests that less capital is flowing into productive activities.

At the same time, real estate investment, which accounts for about one-quarter of FAI, has outpaced overall FAI. China's new home prices in July witnessed their biggest rise since January 2011 in the nation's four major cities, led by a 17 percent jump in Guangzhou and Shenzhen. Some analysts attributed the home price gains to a new government policy to

stimulate the economy by constructing low-cost housing and refurbishing shantytowns.<sup>40</sup> Yet, it may just also signal a new housing bubble; as recently as March, the government intensified a three-year campaign to cool housing prices.<sup>41</sup>

Excess investment has coincided with ongoing credit growth. Total social financing, the aggregate financing measure used by the Chinese government, actually grew faster in June and July than in previous months, in spite of the June credit squeeze. The value of bonds issued also shot up in July and August. Government, central bank, and financial sector bonds accounted for the majority of issuances. Corporate bonds, the most underdeveloped area of the bond market, accounted for just a small share, suggesting that enterprises continued to depend on government subsidies and bank loans for credit.

Meanwhile, China's banks reported in August that their finances were in bad condition. The credit rating agency Standard & Poor's reported in late August that it had examined the balance sheets of 151 major Chinese companies – three-quarters of them state-owned enterprises – and noted that the majority were saddled with "a large debt hangover".<sup>42</sup> In order to aid struggling borrowers in the industrial sector, several banks have taken larger write-offs on loans than in the past. Non-performing loans at the major banks are growing at their fastest levels since the banks were restructured a decade ago. Bank of China, upon reporting weak results for the first half of the year, stated that it had "expanded the channels" for bad loan disposals, but gave no further details.<sup>43</sup> China Construction Bank's chairman stated in late August that the bank had encountered a surge in overdue loans during the first half of the year and could face a "hidden crisis" if the situation worsens.<sup>44</sup> In what appeared to be a direct policy response, Central Huijin, the bank-holding company owned China Investment Corp., China's official sovereign wealth fund, injected large sums into China's "Big Four" commercial banks in late August. The biggest investment was in Industrial & Commercial Bank of China—the country's top lender by assets—buying 721 million yuan (\$118 million) of shares and raising its equity stake from 35.46 percent to 35.50 percent.<sup>45</sup>

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<sup>40</sup> Reuters, "China Services PMI at Five-Month High, Adds to Signs of Recovery," September 4, 2013. <http://www.reuters.com/article/2013/09/04/us-china-economy-hsbc-pmi-idUSBRE98303920130904>.

<sup>41</sup> "China July Home Prices Rise as Nation Seeks Long-Term Policy," *Bloomberg*, August 19, 2013. <http://www.bloomberg.com/news/2013-08-18/china-s-july-home-prices-rise-as-nation-seeks-long-term-measures.html>.

<sup>42</sup> Robin Wigglesworth, "China Companies Face "Credit Deterioration," *Financial Times*, August 19, 2013. <http://www.ft.com/intl/cms/s/0/9cae4fea-08e2-11e3-8b32-00144feabdc0.html#axzz2cQ65iRwP>.

<sup>43</sup> Paul J. Davies, "China Banks Seek to Shake Off Bad Loans," *Financial Times*, August 29, 2013. [http://www.ft.com/intl/cms/s/0/d451ecc4-1083-11e3-b5e4-00144feabdc0.html?ftcamp=published\\_links%2Frss%2Fworld\\_asia-pacific\\_china%2Ffeed%2F%2Fproduct&siteedition=intl#axzz2dMd1ZvXt](http://www.ft.com/intl/cms/s/0/d451ecc4-1083-11e3-b5e4-00144feabdc0.html?ftcamp=published_links%2Frss%2Fworld_asia-pacific_china%2Ffeed%2F%2Fproduct&siteedition=intl#axzz2dMd1ZvXt).

<sup>44</sup> "China Construction Bank Sees Bad Debt Risk," *Wall Street Journal*, August 26, 2013.

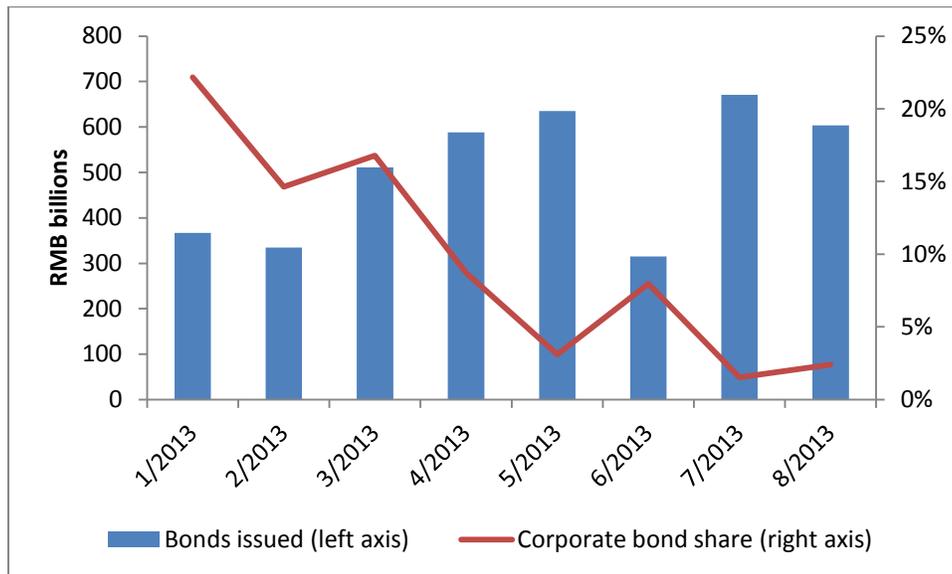
<sup>45</sup> Shen Hong, "CIC Unit Raises Stakes in China's Four Major Banks; Sovereign-Wealth Fund's Investment Arm Is the Biggest Holder of Bank Stocks in China," *The Wall Street Journal Online*, August 29, 2013, via Factiva.

*Growth of Fixed Asset Investment in China*  
Cumulative, year-on-year (%)



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

*Monthly Bond Issuances in China*  
RMB billions



Source: China Central Depository & Clearing Co., Ltd, via CEIC data.

***Economic Reform Agenda to Culminate in November CPC Meetings***

On August 27, China's Communist Party officially announced that it would hold the Third Plenary Session of the 18<sup>th</sup> CPC Central Committee in November. Whereas leaders at last year's meeting were distracted by the Bo Xilai scandal, the meeting this year is expected

consolidate an economic reform agenda that has been outlined by different government agencies throughout 2013.<sup>46</sup>

The priority at the meetings is likely to be financial and fiscal reforms, some of which are already being implemented during the course of the year. In July, the central bank took the unusual step of lifting the floor on bank lending rates. To loosen the capital account, China has vastly increased funding approvals for qualified foreign institutional investors (QFII) this year, including those raising RMB offshore (RQFII). Moreover, in August, China expanded its value-added tax system to some parts of its service and transport sectors nationwide. The reform might be fully in place by the end of 2014, a year ahead of the official schedule. Under the overhaul, firms pay tax only on the value-added portion of their output, rather than the previous business tax that was set at 5 percent of a firm's total sales. The primary motive is to lessen the tax burden on smaller enterprises in the manufacturing sector.<sup>47</sup>

Whether the financial and tax reforms will be successful is questionable. Lending rate reform and opening of the capital account so far have done little to help average Chinese households and small businesses. The central bank maintains a ceiling on deposit rates, which limit the returns that China's depositors receive. The November meetings will indicate whether the government is serious about implementing a deposit insurance scheme, viewed by many as a prerequisite for liberalizing deposit rates. Capital account opening, in turn, has appeared to be geared mainly toward attracting inbound investment – funding approvals for Qualified Domestic Institutional Investors (QDII) have stagnated, while plans for a Qualified Domestic Individual Investor (QDII2) scheme are continually delayed. The recent tax reform, in turn, has run into hurdles, as companies have a tough time proving what portion of their output is value-added, and as a result pay taxes that often exceed 5 percent of their output. Many have reacted by charging their customers higher rates.<sup>48</sup>

Another priority at the November CPC meeting is likely to be urbanization, which addresses several issues, from sustainable resource use to the managed migration of workers from the countryside to the cities. In a sign of reforms to come, China's State Council, the cabinet, in late August approved a 10-year development plan for the city of Changzhou in East China's Jiangsu province. The plan, covering the period 2011-2020, aims to integrate townships and rural areas into a medium-sized city with a fixed acreage and a population that is to remain below 2.48 million by 2020. Rather than expanding, the government is looking to improve the city's existing infrastructure, such as public transport and sewage, in order to make it more environmentally friendly.<sup>49</sup>

In the context of urbanization, some also expect the meeting to address the *hukou* household registration system. In March, departing Premier Wen Jiabao said that *hukou* system reform was central to accelerating urbanization. Although the divisive system has long worked to the advantage of manufacturers in China's coastal regions by reducing social benefits costs of employers and local governments, it has exploited millions of China's migrant workers and limited their ability to transition to the urban middle class. Moreover, the lack of basic social benefits such as medical coverage require migrant workers to put more money into savings as a precautionary measure, which contributes to a higher savings

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<sup>46</sup> "China to Hold Key Economic Reform Meeting in November," *Reuters*, August 27, 2013.

<http://www.reuters.com/article/2013/08/27/us-china-economy-reform-idUSBRE97Q0DC20130827>

<sup>47</sup> "China Tax Overhaul Hits Snags," *Wall Street Journal*, August 15, 2013.

<http://online.wsj.com/article/SB10001424127887324139404579013791440119518.html#printMode>.

<sup>48</sup> "China Tax Overhaul Hits Snags," *Wall Street Journal*, August 15, 2013.

<http://online.wsj.com/article/SB10001424127887324139404579013791440119518.html#printMode>.

<sup>49</sup> "China Approves Changzhou Development Plan," *Xinhua*, August 24, 2013.

[http://www.chinadaily.com.cn/china/2013-08/24/content\\_16918385.htm](http://www.chinadaily.com.cn/china/2013-08/24/content_16918385.htm).

rate and cuts into potential consumption.<sup>50</sup> Replacing the *hukou* system with a nationwide permit system would make equivalent social benefits accessible to rural residents, which could greatly reduce the household savings rate.

Major Chinese cities, notably Chongqing and Chengdu, the two largest cities in Sichuan province in Southwest China, have experimented with *hukou* reforms at the local level. Bo Xilai, when serving as party secretary of Chongqing, awarded urban *hukous* to local farmers whose land was expropriated. However, the central government later shut down the program, and Bo has now fallen out of favor with the leadership and is standing trial for corruption charges. In an effort to attract migrant workers, the Chengdu municipal government has taken similar measures by granting migrant workers originating from nearby villages access to urban social benefits if they rent apartments in the city.<sup>51</sup>

### ***Antitrust Crackdown on Foreign Companies***

China in August continued its crackdown on foreign companies for alleged malpractices. In July, several foreign pharmaceutical and baby formula firms were investigated by Chinese regulators. In an ongoing bribery probe into the British firm GlaxoSmithKline (GSK), at least 20 people were arrested since the beginning of July. Other multinational pharmaceutical companies were also implicated. In addition, China fined six manufacturers of baby formula more than \$100 million for price-fixing, among them New Zealand's Fonterra, the world's largest dairy company. Critics argue that the foreign companies are just convenient scapegoats for the government, which is eager to assuage consumers who are upset about high prices and questionable safety of food and medicine products. The domestic companies that are the main culprits behind a string of scandals surrounding the giant and lucrative markets are either state-owned or too well connected to take on.<sup>52</sup>

The anti-trust campaign became ludicrous in August when company executives were ordered to give confessions on China's state-controlled television. Chinese-American venture capitalist Charles Xue appeared on one show to confess to visiting prostitutes, a crime in China. Peter Humphrey, a British risk consultant accused of buying and selling private information in connection with the GSK case, apologized to the government on CCTV in a neon orange vest and handcuffs, saying he had sometimes used illegal methods in his work. Humphrey and his American wife were detained in July.<sup>53</sup>

### ***Financial Regulators Crack Down on Everbright Securities***

On August 16, a computer error at Everbright Securities, one of China's largest securities brokerages, led to an unexpected surge in the Shanghai Composite index, mainland China's benchmark equity index. A glitch in Everbright's trading system erroneously placed buy orders totaling 23.4 billion RMB (\$3.8 billion). As a result of the flood of unintended buy

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<sup>50</sup> John Ruwitch and Hui Li, "China Eyes Residence Permits to Replace Divisive Hukou System," *Reuters*, March 6, 2013. <http://www.reuters.com/article/2013/03/06/us-china-parliament-urbanisation-idUSBRE92509020130306>.

<sup>51</sup> Bob Davis and Tom Orlik, "China Seeks to Give Migrants Perks of City Life," *Wall Street Journal*, March 5, 2013. <http://online.wsj.com/article/SB10001424127887324178904578341801930539778.html>.

<sup>52</sup> Julien Girault, "Foreign Firms Scapegoats in China Probes: Analysts," *Agence France Press*, August 14, 2013. <http://www.foxnews.com/world/2013/08/14/foreign-firms-scapegoats-in-china-probes-analysts/#ixzz2bwnxLH1p>.

<sup>53</sup> Megha Rajagopalan, "TV Confessions in China an Unsettling New Trend for Executives," *Reuters*, September 2, 2013. <http://www.reuters.com/article/2013/09/01/china-confessions-idUSL4N0GV12P20130901>.

orders, the Shanghai Composite index rose 5.6 percent within seconds, led by other investors buying into the market looking for profit from the unexpected rise. However, word spread of the trading error, and at closing the index was down 0.6 percent. After realizing the order had been made in error, Everbright proceeded to cancel the remaining orders, attempted to sell erroneous purchases, and continued to short the stock index future in order to limit risk and mitigate potential losses incurred as a result of the error.<sup>54</sup>

In response to the mishap, China Securities Regulatory Commission (CSRC) took one of its toughest enforcement actions to date. The CSRC alleged that following the trading glitch, Everbright engaged in insider trading and gave misleading information in an attempt to profit from the error. Consequently, the CSRC temporarily restricted Everbright from trading, imposed fines of 520 million RMB (\$85 million), and seized 87.21 million RMB (\$14.2 million) in trading income for that day. Furthermore, the CSRC also fined five current and former executives and four of them were banned from the industry for life, which led to the resignation of two Everbright officials. Total fines by the CSRC totaled more than half of Everbright Securities' total net profit for 2012.<sup>55</sup>

Critics have questioned whether the Shanghai Stock Exchange should be held to some level of accountability due to CSRC regulations that prohibit securities firms from holding securities worth more than their net capital, which Everbright likely exceeded when in placed orders worth 7.6 billion RMB more than its 2012 net capital. Critics have also pointed to the lack of restraints in its settlement mechanisms of the China Securities Depository and Clearing Co., Ltd. (CSDC), the settlement agency for exchange-market transactions, which has little supervision over institutional traders' buying operations.<sup>56</sup>

The tough penalties imposed on Everbright by the CSRC have been viewed as a positive precedent for further regulatory changes regarding China's securities firms. In the past, China's large securities brokerages have been able to dodge scrutiny and received only minimal penalties for similar mishaps. The tough penalties on Everbright have been attributed to increased scrutiny of China's securities industry led by the new head of CSRC and former Chairman of Bank of China Xiao Gang, and Beijing's attempt to hold more management-level officials accountable in its national campaign to crack down on corruption.<sup>57</sup>

*The U.S.-China Economic and Security Review Commission was created by Congress to report on the national security implications of the bilateral trade and economic relationship between the United States and the People's Republic of China. For more information, visit [www.uscc.gov](http://www.uscc.gov) or [join the Commission on Facebook!](#)*

*This report is the product of professional research performed by the staff of the U.S.-China Economic and Security Review Commission, and was prepared at the request of the Commission to support its deliberations. Posting of the report to the Commission's website is intended to promote greater public understanding of the issues addressed by the Commission in its ongoing assessment of U.S.-China economic relations and their implications for U.S. security, as mandated by Public Law 106-398 and Public Law 108-7. However, it does not necessarily imply an endorsement by the Commission, any individual Commissioner, or the Commission's other professional staff, of the views or conclusions expressed in this staff research report.*

<sup>54</sup> Yang Lu, Fu Yanyan, and Zhou Qun, "The Day Everbright Had to Pull Power Plugs to Stop Erroneous Trading," Caixin, August 28, 2013. <http://english.caixin.com/2013-08-28/100574831.html>.

<sup>55</sup> "China Regulator Fines Everbright Securities," *Wall Street Journal*, August 30, 2013. <http://online.wsj.com/article/SB10001424127887324463604579044421203019730.html?KEYWORDS=Everbright>.

<sup>56</sup> Yang Lu, Fu Yanyan, and Zhou Qun, "The Day Everbright Had to Pull Power Plugs to Stop Erroneous Trading," Caixin, August 28, 2013. <http://english.caixin.com/2013-08-28/100574831.html>.

<sup>57</sup> Simon Rabinovitch, "Tough justice for Everbright," *Financial Times*, September 3, 2013. <http://www.ft.com/intl/cms/s/0/26fc6d7c-144f-11e3-9289-00144feabdc0.html?siteedition=intl#axzz2dpgTsDCO>.