



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

Monthly Summary of U.S.-China Trade Data

July 3, 2013

### Highlights of this month's edition

- **Bilateral trade:** Monthly trade deficit reaches YTD high; U.S. exports drop
- **Bilateral policy issues:** EU-China trade disputes; Shuanghui-Smithfield deal under review (Senate Ag hearing July 10)
- **Sector spotlight:** Money laundering in Macau (USCC hearing); automotive sector deals
- **China's economy:** Unprecedented credit bubble and cash crunch; slow growth in nearly all indicators; Joint venture FDI back on the rise; China loses lead in FDI confidence index; new resource deals in developing countries

### The U.S. Trade Deficit with China Grows

The U.S. trade deficit with China continued to grow in May, registering the largest monthly deficit year to date at \$27.86 billion. U.S. exports continued to decline for the second successive month, down 2.3 percent from April. Continued growth in U.S. imports from China contributed to the rising deficit. Imports were up 10.7 percent from April—a \$3.5 billion increase in value. Compared with 2012, U.S. exports were down 1.3 percent and imports were up 4.9 percent. The growth in total U.S.-China trade value also slowed in May, down 6.6 percent month on month.

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

	Jan	Feb	Mar	Apr	May
Exports	9,385	9,303	9,435	8,992	8,787
Value Imports	37,172	32,715	27,322	33,102	36,646
Balance	-27,787	-23,412	-17,886	-24,110	<b>-27,860</b>

### Top Exports and Imports

Among the top U.S. exports to China, machinery and scrap exports continued to be down from 2012. All of the top-five U.S. imports from China increased in value month on month, which contributed to the increased trade deficit in May. The top-five U.S. exports to China were up in May (except for transportation equipment, which was down 9.7 percent from April), but other U.S. exports underperformed, dropping 11.9 percent month on month. The composition of the top-five imports from China shifted, as computer and electronics experienced the largest drop, 2.8 percent month on month.

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

U.S. Top-Five Exports to China				U.S. Top-Five Imports from China			
	Exports	Share of total (%)	Change over May'12 (%)		Imports	Share of total (%)	Change over May'12 (%)
<i>Monthly (May 2013)</i>				<i>Monthly (May 2013)</i>			
Transportation Equipment	1,634.9	18.6%	58.0%	Computer and Electronic Products	13,985.4	30.5%	12.3%
Computer and Electronic Products	1,494.3	17.0%	16.8%	Electrical Equipment, Appliances, and Component	2,827.6	6.2%	13.5%
Chemicals	1,179.5	13.4%	2.0%	Miscellaneous Manufactured Commodities	2,390.8	5.2%	-11.2%
Machinery, Except Electrical	881.9	10.0%	-2.8%	Machinery, Except Electrical	2,260.5	4.9%	-3.0%
Waste and Scrap	744.3	8.5%	-7.6%	Apparel and Accessories	2,196.7	4.8%	3.4%
Other	2,851.7	32.5%		Other	22,240.0	48.5%	
<b>Total</b>	<b>8,786.5</b>	<b>100.0%</b>		<b>Total</b>	<b>45,901.0</b>	<b>100.0%</b>	
<i>Year-to-date (thru May 2013)</i>				<i>Year-to-date (thru May 2013)</i>			
Transportation Equipment	7,844.2	21.4%		Computer and Electronic Products	61,421.0	36.8%	
Agricultural Products	6,351.6	17.3%		Electrical Equipment, Appliances, and	12,463.7	7.5%	
Computer and Electronic Products	6,277.6	17.1%		Miscellaneous Manufactured Commodities	12,146.5	7.3%	
Chemicals	5,317.0	14.5%		Apparel and Accessories	11,043.2	6.6%	
Machinery, Except Electrical	4,187.5	11.4%		Machinery, Except Electrical	10,023.6	6.0%	
Other	6,668.2	18.2%		Other	59,858.7	35.9%	
<b>Total</b>	<b>36,646.2</b>	<b>100.0%</b>		<b>Total</b>	<b>166,956.7</b>	<b>100.0%</b>	

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

## Bilateral Policy Issues

### ***EU-China Trade Disputes Escalate***

Trade disputes between the European Union and China further escalated in June. On June 4, the European Commission followed through on its month-long threat to impose tariffs on imports of Chinese solar panels. The move came even after Beijing had secured backing from the German government, its largest trade partner and Europe's largest solar panel maker, to oppose the tariff measures. Philipp Rösler, Germany's vice-chancellor and economy minister, referred to the the Commission's action on solar panels as a "a grave mistake". In all, 17 out of 27 EU countries, including the United Kingdom, the Netherlands, and Sweden opposed the measures.<sup>1</sup> Under EU law, though, the EC is permitted to impose provisional duties unilaterally, without input from member states. Only final duties, which in this case are to be decided on in December, will require member approval. Those duties are unlikely to pass.<sup>2</sup>

Nonetheless, pressure from some of its members has compelled the EC to soften its original stance. The body announced in early June that, until August, it would temporarily lower the new tariffs on Chinese panels from the proposed level of 47.6 percent to just 11.8 percent, in order to allow the two sides a chance to negotiate a solution.<sup>3</sup> About two weeks after the tariffs were imposed, the EU and China began technical-level discussions to come to a

<sup>1</sup> Hugh Carnegy and James Fontanella-Khan, "China Clash on Solar Panels Exposed Trade Splits Within Europe," *Financial Times*, June 7, 2013. [http://www.ft.com/intl/cms/s/0/008cfd2-cf72-11e2-be7b-00144feab7de.html?ftcamp=published\\_links%2Frss%2Fworld\\_asia-pacific\\_china%2Ffeed%2F%2Fproduct#axzz2VoxbC0pf](http://www.ft.com/intl/cms/s/0/008cfd2-cf72-11e2-be7b-00144feab7de.html?ftcamp=published_links%2Frss%2Fworld_asia-pacific_china%2Ffeed%2F%2Fproduct#axzz2VoxbC0pf).

<sup>2</sup> Peter Spiegel and Alex Barker, "Brussels to Offer Beijing Reprieve in Solar Panel Dispute," *Financial Times*, June 4, 2013. [http://www.ft.com/intl/cms/s/0/1038136e-cd02-11e2-90e8-00144feab7de.html?ftcamp=published\\_links%2Frss%2Fworld\\_asia-pacific\\_china%2Ffeed%2F%2Fproduct#axzz2VACzJb5P](http://www.ft.com/intl/cms/s/0/1038136e-cd02-11e2-90e8-00144feab7de.html?ftcamp=published_links%2Frss%2Fworld_asia-pacific_china%2Ffeed%2F%2Fproduct#axzz2VACzJb5P).

<sup>3</sup> Leslie Hook, Hugh Carnegy, and Scheherazade Daneshku, "China Launches Investigation into EU Wine Exports," *Financial Times*, June 4, 2013. [http://www.ft.com/intl/cms/s/0/9229031a-cdb1-11e2-8313-00144feab7de.html?ftcamp=published\\_links%2Frss%2Fworld\\_asia-pacific\\_china%2Ffeed%2F%2Fproduct#axzz2VFWfhCDu](http://www.ft.com/intl/cms/s/0/9229031a-cdb1-11e2-8313-00144feab7de.html?ftcamp=published_links%2Frss%2Fworld_asia-pacific_china%2Ffeed%2F%2Fproduct#axzz2VFWfhCDu).

negotiated settlement in the trade dispute. Some experts are optimistic about the outcome of the settlement. For one, they are likely to involve the United States as well, paving the way for a three-way settlement: the United States wants China to lower its duties on U.S. polysilicon exports, while China is concerned about EU tariff duties. Moreover, if the EU and China agree on a minimum price for China's solar exports to preempt price undercutting, that would actually favor solar producers in China.<sup>4</sup>

However, this gesture was insufficient to appease the Chinese government. Just a day after the solar tariffs were announced, Beijing declared that it would launch an investigation into European wine exports to China. Tariffs on wine exports are a clever move by China – its economy can live without imports of luxury goods, whereas many producers in Europe's struggling economy, particularly in Spain and Italy, have come to depend on China, the world's fastest growing export market for wine products.<sup>5</sup>

China's retaliation was followed on June 11 by yet another action by the EU, which filed a complaint to the World Trade Organization (WTO) against Chinese duties on steel tubes used in power plants. The move will allow the EU to join a related complaint filed by Japan against Chinese duties in December, which alleged that China did not have sufficient evidence to back up claims that that Japanese imports were unfairly priced. China was also unwilling to disclose evidence in order to conceal the names of the companies that submitted complaints. The PRC first announced the plan to impose the duties in September 2011, just after the EU introduced similar duties on Chinese stainless steel pipes and tubes in June. Some argued that the complaint bore no relation to the wine and solar disputes, but rather was a response to the deadline to join Japan's complaint. EC spokesman also took pains to show that this was in no way a retaliatory measure. Notably, China did not issue any statement about the issue.<sup>6</sup>

### ***Congress to Examine the Proposed Shuanghui Acquisition of Smithfield***

The Senate Agriculture Committee will hold a hearing on July 10, 2013 on "Smithfield and Beyond: Examining Foreign Purchases of American Food Companies. As reported in the USCC June 2013 trade bulletin,<sup>7</sup> the proposed Shuanghui-Smithfield deal has raised concerned over food safety and protection of American technologies and intellectual property. The hearing also will look at the effects of increased foreign ownership of U.S. food makers.

The hearing follows three separate letters from senators and members of Congress to U.S. Department of Justice, Office of the U.S. Trade Representative, and the U.S. Department of the Treasury, asking for details about the Smithfield deal, ranging from Chinese access to U.S. trade secrets and whether other U.S. meatpackers would have fair treatment in the Chinese market, to how U.S. consumers will know if they are buying U.S.-grown or Chinese meat.<sup>8</sup>

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<sup>4</sup> "EU, China to Start Negotiations on Solar Case Settlement ahead of Ministers Meeting" *Inside US-China Trade* 13:25 (June 19, 2013): 1, 5.

<sup>5</sup> Leslie Hook, Hugh Carnegy, and Scheherazade Daneshku, "China Launches Investigation into EU Wine Exports," *Financial Times*, June 4, 2013. [http://www.ft.com/intl/cms/s/0/9229031a-cdb1-11e2-8313-00144feab7de.html?ftcamp=published\\_links%2Ffrss%2Fworld\\_asia-pacific\\_china%2Ffeed%2F%2Fproduct#axzz2VFWfhCDU](http://www.ft.com/intl/cms/s/0/9229031a-cdb1-11e2-8313-00144feab7de.html?ftcamp=published_links%2Ffrss%2Fworld_asia-pacific_china%2Ffeed%2F%2Fproduct#axzz2VFWfhCDU).

<sup>6</sup> Ethan Bilby, "Exclusive: EU to Seek WTO Ruling Against Chinese Steel Duties – Sources," Reuters, June 11, 2013. <http://www.reuters.com/article/2013/06/11/us-eu-china-wto-steel-idUSBRE95A09C20130611>.

<sup>7</sup> For an in-depth review of the deal, see the June 2013 Trade Bulletin. [http://origin.www.uscc.gov/sites/default/files/trade\\_bulletins/June%202013%20Trade%20Bulletin\\_6%207%2013.pdf](http://origin.www.uscc.gov/sites/default/files/trade_bulletins/June%202013%20Trade%20Bulletin_6%207%2013.pdf).

<sup>8</sup> "Bipartisan Group of Senators Urge Appropriate Oversight of Proposed Smithfield Purchase," June 20, 2013.

<http://www.ag.senate.gov/newsroom/press/release/senators-urge-oversight-smithfield>; "Forbes Expresses Antitrust Concerns Over Chinese Firm's Acquisition of Smithfield Foods," June 27, 2013.

<http://forbes.house.gov/news/documentsingle.aspx?DocumentID=340797>; "DeLauro, Warren Demand Answers On

## Sector Spotlight

### Advanced Technology Product (ATP) Trade

The U.S.-China advanced technology product monthly trade deficit increased by 19 percent in May, up \$1.7 billion. Total ATP exports were down 0.6 percent. Although most ATP exports experienced moderate growth, overall growth in exports was offset by a 25.4 percent drop in aerospace product exports, down \$222 million from April. Growth in total imports, however, was up 15 percent. The jump in imports was driven by information and communication products, which increased by \$1.7 billion month on month, up 16.8 percent.

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

	Monthly			Cumulative year-to-date			
	Exports	Imports	Balance May'13	Exports	Imports	YTD Balance May'13	YTD Balance May'12
<b>TOTAL</b>	<b>2,114</b>	<b>12,588</b>	<b>-10,474</b>	<b>9,941</b>	<b>54,915</b>	<b>-44,974</b>	<b>-44,591</b>
(01) Biotechnology	30	5	25	152	30	122	71
(02) Life Science	255	173	82	1,156	840	316	221
(03) Opto-Electronics	28	363	-335	129	1,698	-1,569	-2,990
(04) Information & Communications	431	11,582	-11,151	1,806	50,189	-48,383	-45,123
(05) Electronics	434	280	154	1,872	1,329	543	295
(06) Flexible Manufacturing	265	79	186	977	357	620	296
(07) Advanced Materials	16	23	-7	92	93	-1	24
(08) Aerospace	651	71	580	3,551	327	3,224	2,633
(09) Weapons	0	13	-13	1	52	-51	-47
(10) Nuclear Technology	5	0	5	204	1	203	28

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

Ford and General Motors announced ambitious plans on June 19 to increase production in China, the world's largest market. GM announced that it would begin construction of a new \$1.3 billion plant, which will be able to produce 160,000 Cadillac vehicles a year. The aim is to increase GM's share of China's luxury car market from 2.5 percent to 10 percent by 2020. Ford, in turn, announced a new \$500 million engine plant in Chongqing capable of producing 400,000 engines a year. The move is part of Ford's largest expansion in over half a century, with seven new plants under construction in the Asia-Pacific region.<sup>9</sup>

Meanwhile, on June 25-26, the United States and China participated in the first WTO hearing for the U.S. challenge of Chinese trade remedies in the auto sector. The panel was set up last October. The United States alleges that China has imposed antidumping and countervailing duties on U.S. cars as a "misuse and retaliatory use of trade remedy measures." China launched its AD and CVD investigations in fall 2009, arguably in retaliation for the Obama administration's imposition of duties on Chinese tires.<sup>10</sup>

Shuanghui-Smithfield Foods Deal," June 27, 2013.

[http://delauero.house.gov/index.php?option=com\\_content&view=article&id=1328:delauero-warren-demand-answers-on-shuanghui-smithfield-foods-deal&catid=2:2012-press-releases&Itemid=21](http://delauero.house.gov/index.php?option=com_content&view=article&id=1328:delauero-warren-demand-answers-on-shuanghui-smithfield-foods-deal&catid=2:2012-press-releases&Itemid=21).

<sup>9</sup> Richard Davies, "Big Boost for GM and Ford in China," *ABC News*, June 19, 2013.

<http://abcnews.go.com/blogs/business/2013/06/big-boost-for-gm-and-ford-in-china/>.

<sup>10</sup> "U.S., China to Hold First Panel Meeting in U.S. Challenge of Chinese Auto Duties," *Inside US-China Trade* 13:25 (June 19, 2013), p.2.

## **Money Laundering in Macau**

On June 27, the USCC held a hearing on Macau and Hong Kong. The Macau segment of the hearing highlighted Macau casinos' vulnerability to money laundering and its implications for the United States. Witness testimony is available on the USCC website, and the full hearing transcript will be posted at a later date.

Macau officially surpassed Las Vegas as the world's largest gambling market in 2006, and has continued to grow rapidly. In 2012, Macau's annual gross gaming revenue (GGR) reached \$38 billion, more than six times that of the Las Vegas Strip.<sup>11</sup> The growth of Macau's gaming industry is largely driven by visitors from mainland China. According to the Macau SAR Statistics and Census Service, 60 percent of the 16.9 million people who visited Macau in 2012 originated from mainland China. Other visitors are primarily from Hong Kong or Taiwan.<sup>12</sup>

The PRC's strict capital controls limit the amount that can be moved outside of China by an individual to RMB20,000 (\$3,150) per trip. These restrictions have given rise to grey market channels for mainland Chinese to move money outside of the mainland. In Macau, the most notable channel is through Macau casino junket operators, or "gaming promoters." Gaming promoters hire agents which extend gambling credit to wealthy mainland Chinese clients to use in Macau casinos' VIP rooms, allowing them to circumvent China's capital controls. In turn, these agents collect debts incurred by clients in Macau casinos back on the mainland, often through illegal means. The gaming promotion industry in Macau is not subject to the same strict reporting requirements as banking institutions, and therefore presents a potential risk for money laundering. At the USCC hearing, U.S. federal and state regulators expressed concern that Macau's gaming promoters and VIP rooms increase the difficulty in accessing whether U.S. casino companies operating in Macau are complying with U.S. regulations.

One indicator of the increasing money laundering problem in Macau is the rising number of suspicious transaction reports (STR) filed with Macau's Financial Intelligence Office (GIF), an independent unit established by the Macau government to investigate money laundering and financing of terrorists. In 2012, the number of STRs filed increased 18 percent year on year, and 72 percent of the total 1,840 reports filed originated from the gaming industry.<sup>13</sup>

Recent reports have signaled that Beijing is discussing taking measures to stem money laundering in Macau as part of the crackdown on corruption promoted by Xi Jinping. The PRC's recent appointment of former Hong Kong liaison Li Gang to deputy director of the Central Liaison Office in Macau was seen as an effort to gain closer oversight over Macau's gaming industry.<sup>14</sup> The ability of the government in Beijing to curtail the flow of money from the mainland to Macau remains to be seen. Macau's June gaming revenue was up 21.1 percent year on year. HSBC has also remained bullish on Macau and does not foresee China's crackdown on corruption as having a significant impact on the amount of money flowing into the SAR.<sup>15</sup>

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<sup>11</sup> Gaming Inspection and Coordination Bureau (DICJ), "Gaming Statistics."

[http://www.dicj.gov.mo/web/en/information/contacts\\_casino/content.html#sjm](http://www.dicj.gov.mo/web/en/information/contacts_casino/content.html#sjm).

<sup>12</sup> Government of Macao Special Administrative Region Statistics and Census Service, "Visitor Arrivals and Same-day Visitor Arrivals by Place of Residence." <http://www.dsec.gov.mo/TimeSeriesDatabase.aspx>.

<sup>13</sup> Macau SAR Financial Intelligence Office (GIF), *Financial Intelligence Office Newsletter for Financial Sector* 9 (Macau: May 2013), p.1

<sup>14</sup> Reuters, "Gamblers Not So Anonymous: Beijing Keeps Closer Eye on Macau," April 29, 2013.

<http://www.reuters.com/article/2013/04/29/us-casinos-macau-china-idUSBRE93S0XK20130429>.

<sup>15</sup> HSBC *Week in China*, "The House is Still Winning," May 10, 2013

## **China's Economy**

In June, data showed China's economy taking an increasingly negative turn. Key indicators showed slow growth for May, coupled with a growing risk of a credit bubble. The market also felt the impact of a new administration in Beijing that is imposing stronger measures to rein in debt and to steer the economy toward long-term structural reform. In light of these and other negative factors, several banks cut their GDP forecasts for China.

Credit markets took center-stage once again in June, when the cost of accessing credit was both higher and more volatile. Analysts have struggled to interpret the data, and to understand how the new government of President Xi Jinping plans to tackle issues like "shadow banking" and real estate speculation without destabilizing the real economy.

JPMorgan was particularly bearish, cutting its forecast from 7.8 percent to 7.6 percent – lower even than China's first-quarter growth of 7.7 percent, and just 0.1 percent higher than Beijing's growth target of 7.5 percent.<sup>16</sup>

The current deputy secretary-general of the China's State Council, Ding Xuedong, has been reported as a likely candidate to fill the vacant chairman position at China's \$500 billion sovereign wealth fund, China Investment Corporation. If appointed, he will succeed previous chairman Lou Jiwei, who left the fund in March after being appointed Minister of Finance. The prolonged vacancy has given rise to media speculation of who will head the fund, which falsely speculated that director of SAFE Yi Gang, Shanghai mayor Tu Guangshao, and others as possible successors. Like Lou, Ding has experience working in leadership positions at the Ministry of Finance, having served as deputy finance minister from 2008-10 and in other roles dating back to 1987.<sup>17</sup> China Investment Corporation's 2012 annual report is due to be published at the end of this month.

### ***Slowdown in Most Key Indicators***

The latest data on the real economy points to anemic growth. Export growth fell to 1 percent year-to-year in May, the lowest growth since July of last year, and a sharp drop from previous months. The export figures appeared to be a corrective for data in the prior months, which had shown strong export growth in spite of weak GDP figures. Many analysts had questioned the accuracy of those figures, attributing them to over-invoicing rather than real shipments.

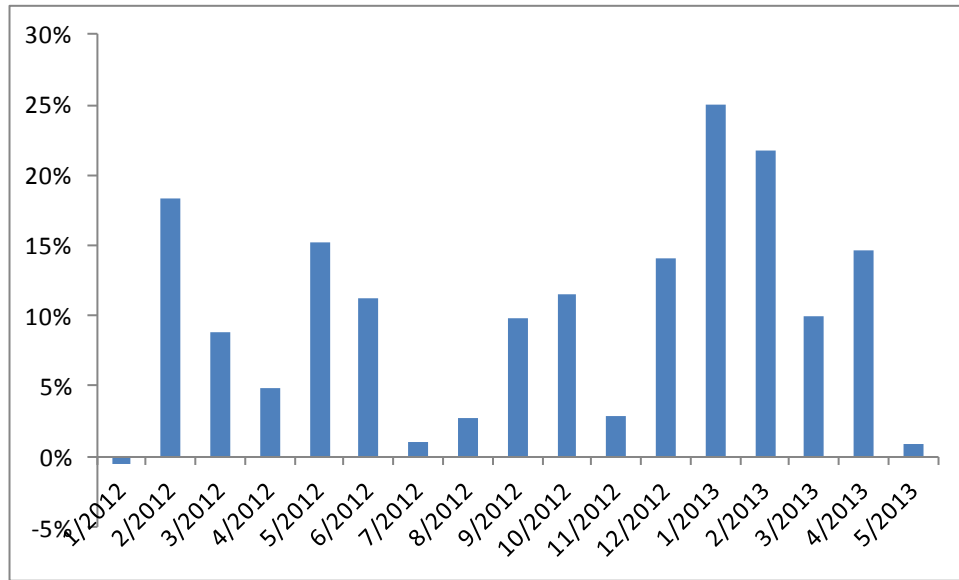
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<sup>16</sup> Bloomberg, "China Lending Data May Be Overstated, Credit Suisse Says," June 7, 2013.

<http://www.bloomberg.com/news/2013-06-07/china-lending-data-may-be-overstated-credit-suisse-says.html>.

<sup>17</sup> Linling Wei, "Low-Key Politician to Take Helm of China's \$500 Billion Fund," *The Wall Street Journal*, June 30, 2013. <http://online.wsj.com/article/SB10001424127887324328204578572511050273652.html#printMode>.

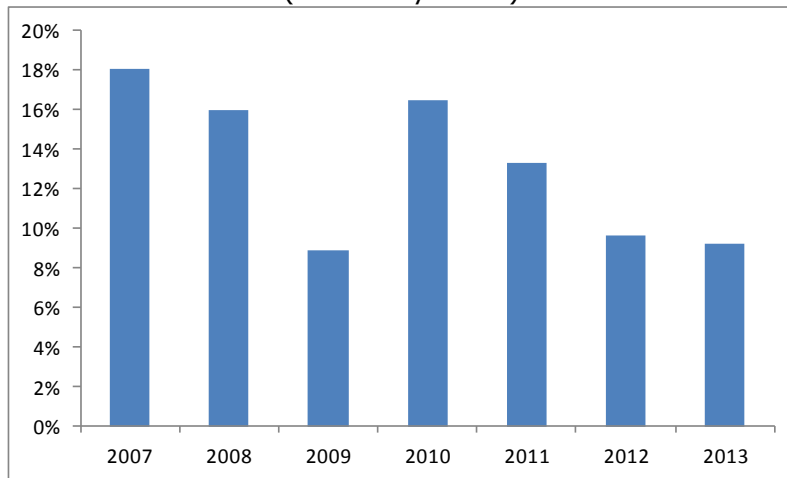
*Year-on-Year Growth in Exports, January 2012 to May 2013*



Source: General Administration of Customs, via CEIC data.

Weak exports correlated with flagging industrial output. Year-on-year growth in May was 9.2 percent, the lowest level for that month since 2009. The purchasing managers' index also reflected a lack of optimism among producers.

*Value-Added of Industry: Year-on-Year Growth in May, 2007-2013*  
(Year-on-year %)

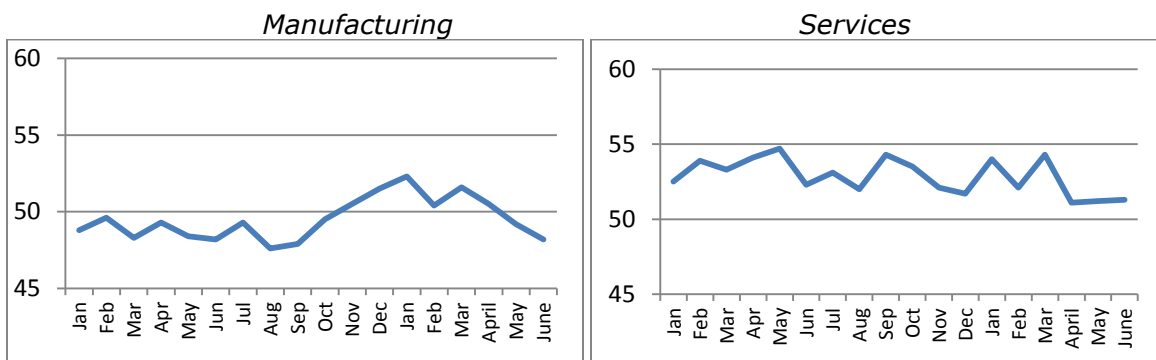


Source: China National Bureau of Statistics, via CEIC data.

The HSBC purchasing managers' index (PMI) for the manufacturing industry was reported at 48.2 for the month of June, down from 49.2 in May. The manufacturing PMI has worsened for two successive months, signaling a continued, gradual reduction in manufacturing output. The drop from last month was attributed to weak client demand, a sharp decline in new orders from abroad, and the PBOC instigated cash crunch (detailed below). The HSBC services PMI experienced modest expansion in June at 51.3, up from 51.2 in May. Total orders continued to grow and employment experienced a slight increase, but growth in new orders underperformed. Although input costs rose in June, service providers' output charges

declined for the second successive month in an attempt to attract new business. Uncertain stability in client demand remains a main concern of service providers.

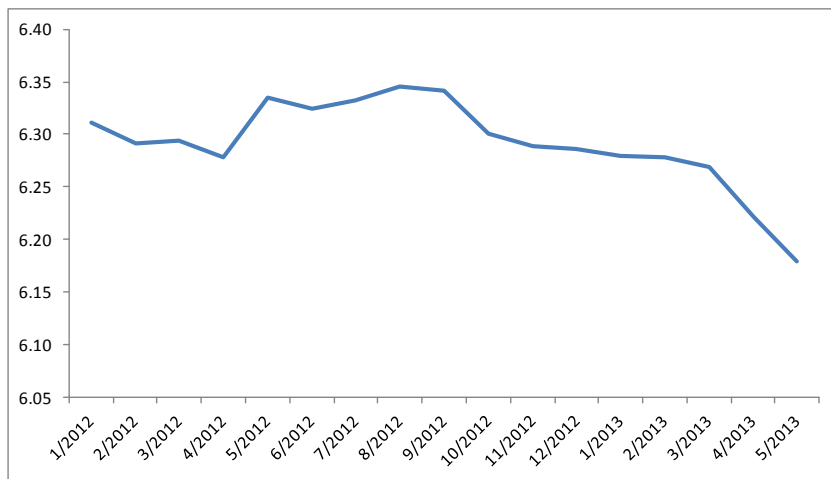
*Purchasing Managers' Index through June 2013 (Manufacturing)*  
 (<50 = contraction, >50 = expansion)



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

Several factors help to explain the slowdown in exports and output. Exports probably took a hit from weak demand in Europe, China's top trade partner. Trade disputes between Brussels and Beijing escalated in June (see above). Another factor that may have affected exports was currency appreciation. The RMB has risen strongly against the dollar and the euro, hitting sales of exporters and squeezing their profits.<sup>18</sup> Although appreciation slowed in June, it was still far higher than at year-end 2012.

*People's Bank of China Month-End Exchange Rate through May 2013*



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

Another factor was the latent effect of real wage increases: the average monthly wage for migrant workers at the end of 2012 was 11.8 percent higher than in 2011, according to official data.<sup>19</sup> *The Wall Street Journal* reported that some smaller firms have left Shenzhen

<sup>18</sup> "Strains Show in China's Job Market," *The Wall Street Journal* online, June 11, 2013.  
<http://online.wsj.com/article/SB10001424127887324904004578537251643591248.html>.  
<sup>19</sup> "Strains Show in China's Job Market," *The Wall Street Journal* online, June 11, 2013.  
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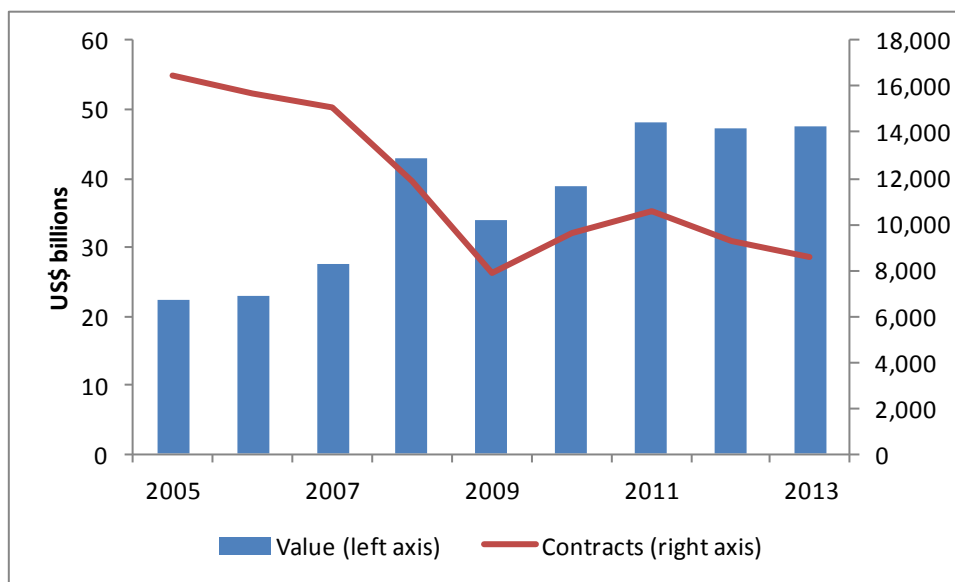


for nearby cities where labor and land are cheaper, in turn prompting labor disputes when workers refused to move.<sup>20</sup> China Labor Bulletin, a Hong Kong-based labor group, recorded 201 cases of labor disputes in the first four months of the year, almost double the number of cases in the same period last year. A survey of more than 4,000 employers by human-resources consultancy Manpower Group found that the net employment outlook – the difference between the percentage of firms anticipating adding workers and the percentage planning to reduce head count in the quarter ahead – deteriorated to 12 percent in the second quarter, the lowest level since the end of 2009.<sup>21</sup>

### **Foreign Direct Investment Slows, with More JVs**

Statistics published on June 21 indicate that foreign direct investment in China has slowed down along with exports, expanding just one percent year-on-year through May. FDI was about \$400 million lower than at the same point in 2011, when China’s FDI witnessed a strong rebound after the global financial crisis. The number of FDI transactions has declined even more – the number of contracts increased along with FDI value in 2009-11, but the past two years indicate a disjunction between the two, resulting in higher FDI value per contract.

*Inbound Foreign Direct Investment in China, January - May, 2005-2013  
(FDI Value and Total Contracts)*



Source: China Ministry of Commerce, via CEIC data.

In a further setback to foreign investors, the Supreme People’s Court, the highest court in China, found in June that contracts used by non-Chinese citizens to gain access to sectors of the Chinese economy that are protected from foreign investment were invalid. Certain industries within sectors deemed sensitive by the Chinese government are off-limits to foreign investment. Foreign companies circumvented the restrictions by partnering with domestic firms through so-called variable interest entities (VIEs). However, as a result of the new ruling, contracts used by non-Chinese citizens to gain access to protected sectors (i.e. to avoid the requirements of Chinese law) are void and the court will not enforce them.

<sup>20</sup> “Strains Show in China’s Job Market,” *The Wall Street Journal* online, June 11, 2013. <http://online.wsj.com/article/SB10001424127887324904004578537251643591248.html>.

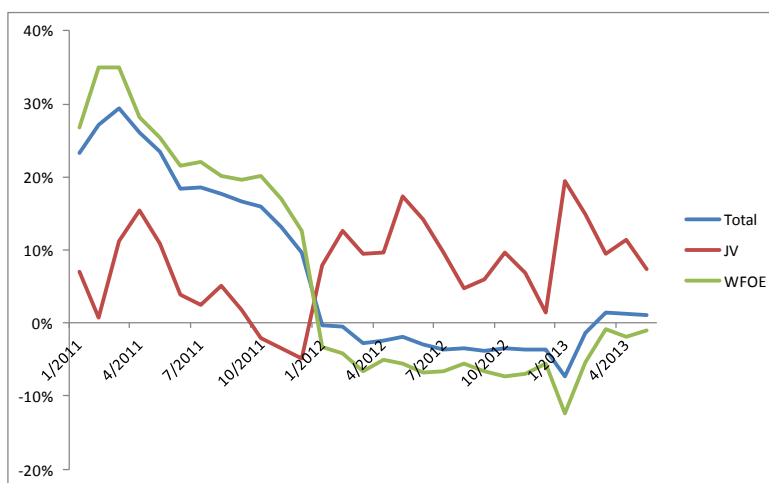
<sup>21</sup> “Strains Show in China’s Job Market,” *The Wall Street Journal* online, June 11, 2013. <http://online.wsj.com/article/SB10001424127887324904004578537251643591248.html>.

In effect, Chinese partners can renege on those contracts – for instance, after securing sufficient intellectual property and know-how – without providing their foreign partners any legal recourse in China’s judicial system. The move is likely to affect companies in the service industry.<sup>22</sup>

It is interesting that the sole reason for China’s FDI growth in 2012-13 is the expansion of joint ventures. That goes against the grain of what happened in the decade after China joined the WTO. During those years, foreign enterprises increasingly turned away from JVs and other forms of cooperative investments, in favor of wholly foreign-owned enterprise (WFOE) investments. WFOEs increased their share of inbound investment into China from 36 percent to 77 percent in 1997-2012. However, the trend has now shifted slightly – for the first time, WFOE FDI is declining, while JV investment is up. The share of JVs in cumulative FDI for the first five months of the year reached its highest level since 2006.

Several factors may explain this. The original attraction of WFOEs was a preference for managerial autonomy, concern over intellectual property rights, and importantly, preferential tax rates. The latter factor has been eliminated – WFOEs no longer enjoy the tax breaks.

*Growth in Value of Foreign Direct Investment in China, January 2011 to May 2013  
(Year-on-year %)*



Source: China Ministry of Commerce, via CEIC data.

Note: WFOE refers to wholly foreign-owned enterprise. JV refers to joint venture.

### **China Drops in Foreign Direct Investment Confidence Index Ranking**

China dropped from first place in the 2013 Foreign Direct Investment Confidence Index, a survey of global executives conducted by global management consulting firm A.T. Kearney that ranks countries overall foreign direct investment climate, and was displaced by the United States. This is the first time that China has been downgraded from the top rank since 2001, when it first surpassed the United States. The drop was largely due to increasing labor and transportation costs along with an appreciating currency that have resulted in a decrease in the country’s global competitiveness. Growing confidence in the United States, however, resulted in a jump to the top from fourth place in 2012. The increased attractiveness for FDI in the United States has been attributed to rising U.S. worker

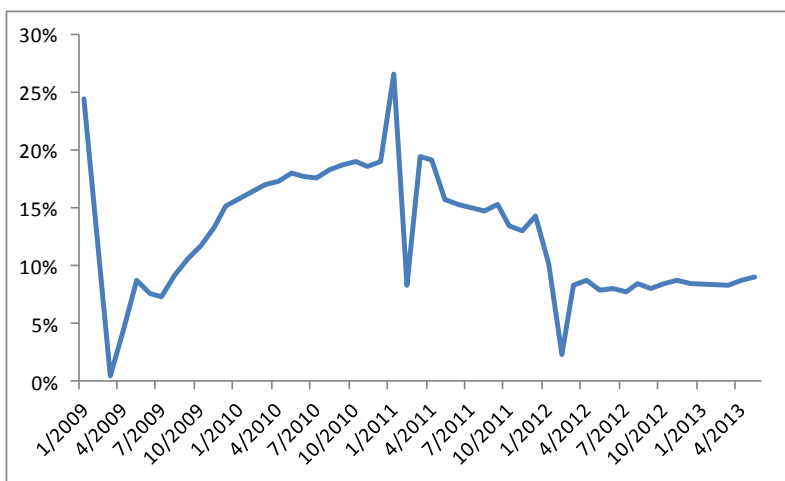
<sup>22</sup> Sue-Lin Wong, “China Court Ruling Could Threaten Foreign Investments in Country,” *New York Times*, June 17, 2013. <http://rendezvous.blogs.nytimes.com/2013/06/17/china-court-ruling-could-threaten-some-foreign-invested-companies/>.

competitiveness, the recovering housing market, and increased oil and gas production—economic indicators that signal an overall stronger economy.<sup>23</sup>

### **Rebalancing Indicators: Consumer Growth and Non-Manufacturing Output**

Figures for retail in May were not as negative as those for exports and manufacturing. But even here, growth was only steady, and nowhere near the levels of 2011.

*Year-on-Year Growth of Retail Sales in China: Survey of 3,000 Key Retail Enterprises*  
(Year-on-year %)



Source: China Ministry of Commerce, via CEIC data.

The strong increase in wages in China may be hurting the competitiveness of factories, but does not appear to be affecting overall demand for workers outside the factory sector. May data from Zhaopin.com, a leading recruitment website used primarily by white collar workers, showed a record number of new positions posted – up from a sharp slowdown in such postings the month before. This suggests that outside the factory sector, the hiring picture may be stronger.<sup>24</sup>

The looming question, however, is whether China’s labor market can restructure fast enough to account for a larger pool of knowledge workers. A record seven million students graduated from universities and colleges across China in June. *The New York Times* reports that many businesses in China are “swamped with job applications but have few positions to offer as economic growth has begun to falter.” By contrast, only four percent of those with an elementary school education were unemployed. That suggests that, even if factories might shed jobs at a faster pace than white collar businesses in the short run, the underlying demand is still for low-wage blue-collar workers who migrate from the countryside to the city. That is also reflected in differences in wage growth: workers who have come in from rural areas to urban factories have seen their wages go up 70 percent, while wages in white-collar sectors have been steady to declining.<sup>25</sup>

<sup>23</sup> Reuters, “U.S. Tops Confidence Survey on Foreign Investment, Displaces China,” June 26, 2013. <http://www.reuters.com/article/2013/06/26/us-fdi-survey-idUSBRE95P05X20130626>.

<sup>24</sup> “Strains Show in China’s Job Market,” *The Wall Street Journal* online, June 11, 2013. <http://online.wsj.com/article/SB10001424127887324904004578537251643591248.html>.

<sup>25</sup> Keith Bradsher and Sue-Lin Wong, “Faltering Economy in China Dims Job Prospects for Graduates,” *New York Times*, June 16, 2013. <http://www.nytimes.com/2013/06/17/business/global/faltering-economy-in-china-dims-job-prospects-for-graduates.html?pagewanted=all&r=0>.

## **Credit Bubble...**

While China's economy is slowing, its credit bubble is inflating to unprecedented levels. The extent of the credit bubble is readily apparent when looking at "social financing", a broad measure of credit in China's economy that includes financing outside traditional bank lending, such as corporate bonds and informal lending.<sup>26</sup> Social financing jumped 52 percent year-on-year in the period January to May, and reversed a decline in credit expansion in 2010-12. One of the puzzles is that, in the first quarter of the year, there was a 12-point gap between the growth of outstanding credit and nominal GDP. Many economists had been perplexed by the gap between lending and economic growth.<sup>27</sup> According to Mathias Drehmann of BIS, when the deviation exceeds 10 percent of GDP, it "serves as a reliable early warning of a crisis within the next three years."<sup>28</sup>

Several theories have been put forward to account for the surge in credit and letdown in economic growth. Optimists point to a time lag before credit filters through the economy, especially when industrial output and private consumption are weak.<sup>29</sup> But as M.K. Tang of Goldman Sachs has noted, investment in China is becoming much less efficient. Gross fixed capital formation, which measures the investment that actually goes into new physical assets and contributes to GDP, now accounts for just 70 percent of total fixed asset investment, versus nearly 100 percent in 2008. That suggests that existing assets are changing hands at a quickening pace and a rising price.<sup>30</sup> The recent surge in real estate prices backs Tang's point. China's new-home prices jumped 6.9 percent in May from a year earlier, the most since they reversed declines in December, according to SouFun, the country's biggest real estate website owner.<sup>31</sup>

A bigger force behind the credit surge is Chinese enterprises that are mired in debt, and are paying higher interest to refinance it. Corporate bond financing has nearly doubled to RMB 1.2 trillion. This issue was acknowledged by China's financial regulators in meetings with Credit Suisse, the Swiss bank.<sup>32</sup>

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<sup>26</sup> The central bank started releasing aggregate financing data in 2011 to provide a broad picture of funding, as the traditional bank-lending indicator became insufficient, accounting for less than half of the total. Bloomberg, "China Lending Data May Be Overstated, Credit Suisse Says," June 7, 2013. <http://www.bloomberg.com/news/2013-06-07/china-lending-data-may-be-overstated-credit-suisse-says.html>.

<sup>27</sup> Bloomberg, "China Lending Data May Be Overstated, Credit Suisse Says," June 7, 2013. <http://www.bloomberg.com/news/2013-06-07/china-lending-data-may-be-overstated-credit-suisse-says.html>.

<sup>28</sup> "Taking Credit for Nothing," *Economist*, June 15, 2013. <http://www.economist.com/news/finance-and-economics/21579445-chinas-credit-boom-has-got-people-worried-should-they-be-taking-credit?frsc=dg%7Ca>.

<sup>29</sup> Bloomberg, "China Lending Data May Be Overstated, Credit Suisse Says," June 7, 2013. <http://www.bloomberg.com/news/2013-06-07/china-lending-data-may-be-overstated-credit-suisse-says.html>.

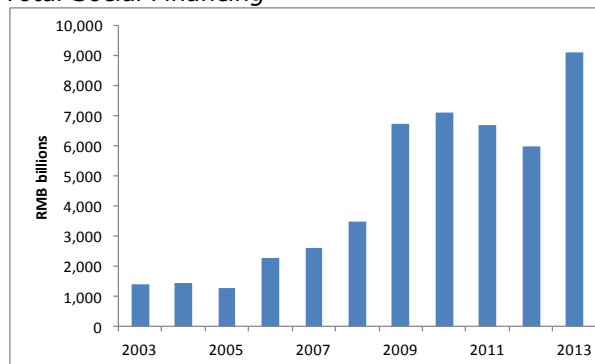
<sup>30</sup> "Taking Credit for Nothing," *Economist*, June 15, 2013. <http://www.economist.com/news/finance-and-economics/21579445-chinas-credit-boom-has-got-people-worried-should-they-be-taking-credit?frsc=dg%7Ca>.

<sup>31</sup> Bloomberg, "Beijing Tightens Presale Rules as Home Prices Rise under Curbs," June 17, 2013. <http://www.bloomberg.com/news/2013-06-17/beijing-tightens-presale-rules-as-home-prices-rise-under-curbs.html>.

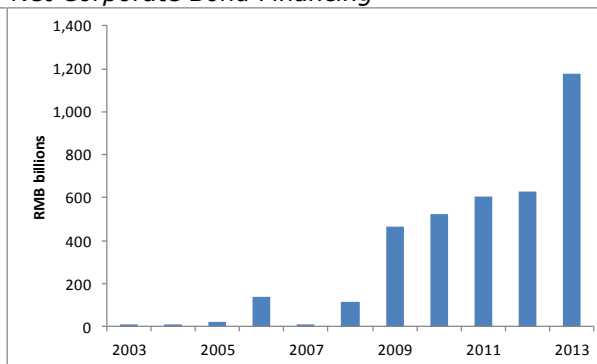
<sup>32</sup> Bloomberg, "China Lending Data May Be Overstated, Credit Suisse Says," June 7, 2013. <http://www.bloomberg.com/news/2013-06-07/china-lending-data-may-be-overstated-credit-suisse-says.html>.

*Broad Credit Expansion in China, January - May, 2002-2013*  
(US\$ billions)

*Total Social Financing*



*Net Corporate Bond Financing*



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

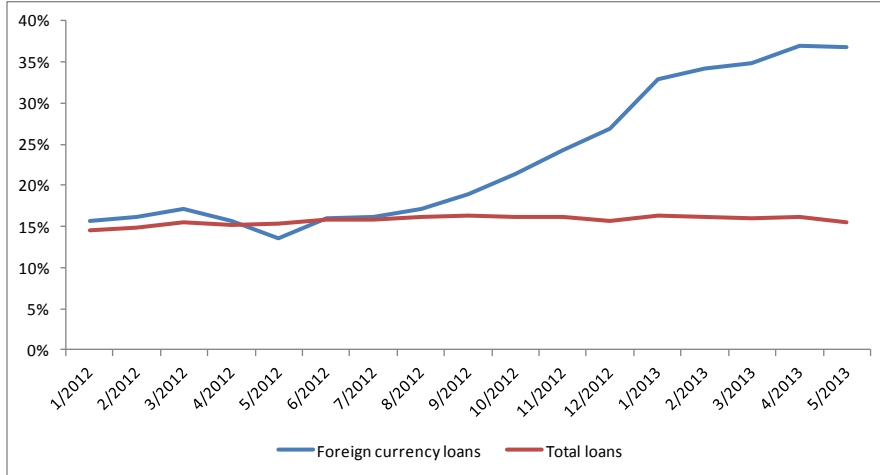
Local governments are highly leveraged as well. A total of 16 provinces and two municipalities representing more than 60 percent of China's GDP have "issued statements since the start of the second quarter proclaiming the importance of investment projects in driving growth and urging lower levels of government to use all means to accelerate plans in the months ahead." For example, Zhejiang aims for 1,000 large-scale investment projects in infrastructure, water conservancy and auto manufacturing over the next five years. In April, the government of Yunnan met with local banks to request funds in support of plans to invest about RMB 166.8 billion in infrastructure and other projects. More than three-quarters of that funding is coming from bank loans.<sup>33</sup>

Besides heavy leveraging by enterprises and local authorities, the false reporting of data has also inflated the credit figures. The Chinese government essentially admitted to over-invoicing of trade in April, when it drastically revised China's export figures for 2012. Financial regulators told Credit Suisse that credit expansion may indeed be overstated due to bill financing for non-existent trade. Further, several international banks have argued that some of the lending data in China's under-regulated "shadow banking" sector is inaccurate; in particular, some Chinese companies have used loans to buy wealth management products that are recorded a second time in another category. Bank of America estimated that this "double-counting" explained up to 3 percent of the 12-point gap between outstanding credit and nominal GDP.<sup>34</sup>

Foreign currency lending in the traditional banking sector has also propelled overall credit expansion. While total loan growth at banks has been fairly constant this year, it has skyrocketed for loans denominated in dollars and other currencies.

<sup>33</sup> Oddly, the central government decided in late June to allow more provincial governments to sell bonds directly. So far, only Guangdong and Zhejiang have been permitted to do so, with all other bond issuances originating with the central government. Shandong and Jiangsu have now been added to the list. The upside, apparently, is that local government financing will become more transparent, and funding requests will have to be better justified. Wall Street Journal, "China Expands Local Bond Program," June 19, 2013. <http://online.wsj.com/article/SB10001424127887323393804578554923845795466.html>; Wall Street Journal, "Across China, the Itch to Spend Is Strong," June 11, 2013. <http://online.wsj.com/article/SB10001424127887324904004578536623743261576.html>.  
<sup>34</sup> Bloomberg, "China Lending Data May Be Overstated, Credit Suisse Says," June 7, 2013. <http://www.bloomberg.com/news/2013-06-07/china-lending-data-may-be-overstated-credit-suisse-says.html>.

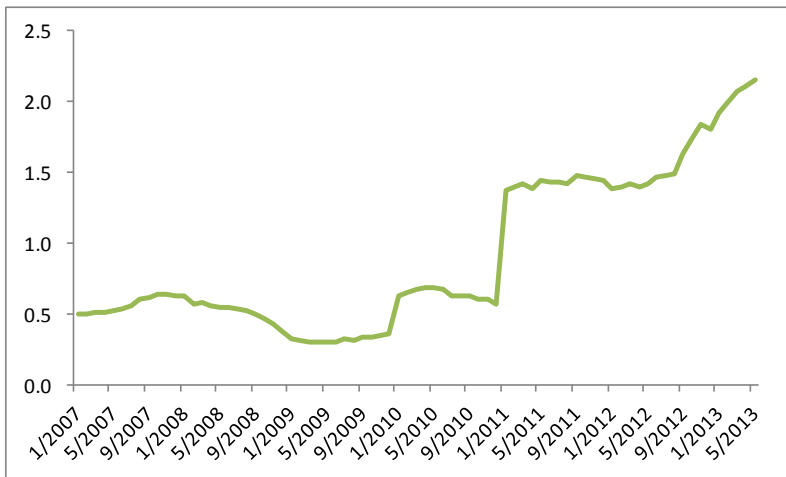
*Year-on-Year Growth in Loans, Foreign vs. Total*



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

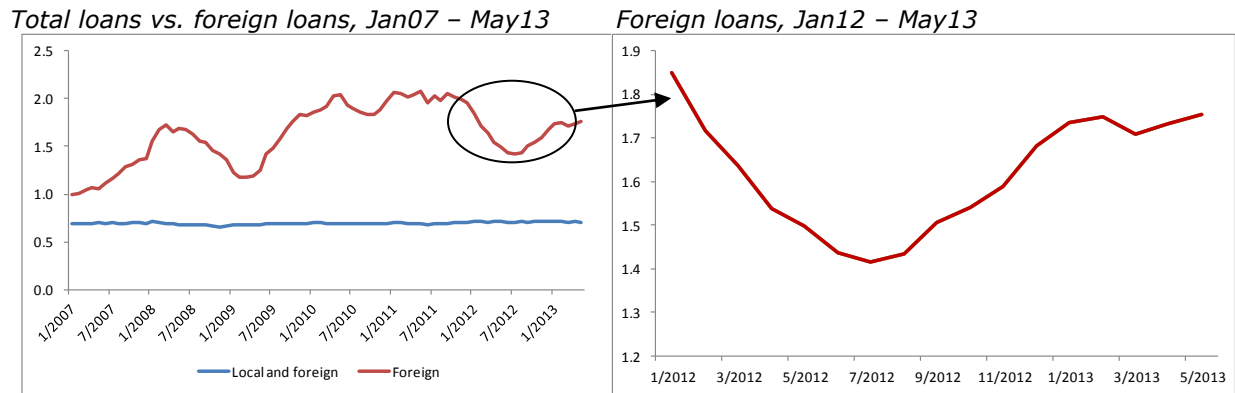
The surge in foreign currency loans has come via heavy leveraging by China’s commercial banks. The ratio of short-term foreign currency loans has witnessed a sharp increase. Likewise, there has been a notable increase in the loan-deposit ratio (LDR) for foreign currency loans over 2012. When lending foreign currency, Chinese banks are less restricted in terms of the amount of deposits they need to have available – this loose regulation has been relentlessly exploited during the recent lending surge.

*Foreign Currency Loans: Ratio of Short-Term to Medium/Long-Term Loans*



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

## Loan-Deposit Ratio



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

Foreign currency loans have also been backed by inflows of foreign currency. In the first quarter of this year, Chinese banks' foreign-exchange purchases skyrocketed to a record \$195 billion – more than double last year's total. April was the fifth consecutive month of growth. Over the same period, China's foreign-exchange reserves swelled by \$128 billion, to \$3.4 trillion – the largest quarterly increase since 2011 and equal to the total rise in 2012. Because China's trade surplus and foreign investment have totaled little more than \$70 billion this year, a big chunk of the inflows is coming from capital markets.<sup>35</sup> The RMB has appreciated against the dollar in recent months, while the Federal Reserve in the United States has maintained a quantitative easing (QE) policy that offers low interest rates to borrowers. That has led many investors to borrow dollars cheaply and spend them on assets denominated in RMB. In turn, with no sign of improved economic fundamentals in China, the RMB's rapid rise is being reinforced by those foreign-currency inflows.<sup>36</sup> There might also be a policy dimension to this, as Beijing tolerates a stronger RMB as part of plan to ease capital controls later this year. If the RMB were much below its market value, relaxing capital controls could invite a destabilizing influx of foreign money. The Catch-22 for Beijing is that currency appreciation, at least in the short run, will continue to attract more currency speculators.<sup>37</sup>

### **...and Cash Crunch**

The combination of the credit bubble and slowing growth has left the Chinese economy in a dangerous situation. At Nomura, analysts posited in June that there is a 30 percent chance China's GDP may fall below 7 percent in the third or fourth quarter. They argued that, because China's economy is now highly leveraged, liquidity tightening has become dangerous: many borrowers could default, with knock-on risks for social stability. Such tightening could occur as a function of Beijing's efforts to rein in debt. More ominously, it could come from a slowdown of capital flows into China.<sup>38</sup>

In June, the effects of a credit bubble began to destabilize China's economy. Lenders became less willing and able to lend, in what quickly snowballed into a "cash crunch". In the

<sup>35</sup> Zhang Monan, "China's Cold Eye on Hot Money," *Project Syndicate*, June 10, 2013. <http://www.project-syndicate.org/commentary/china-s-new-rules-for-managing-cross-border-capital-flows-by-zhang-monan>.

<sup>36</sup> Zhang Monan, "China's Cold Eye on Hot Money," *Project Syndicate*, June 10, 2013. <http://www.project-syndicate.org/commentary/china-s-new-rules-for-managing-cross-border-capital-flows-by-zhang-monan>.

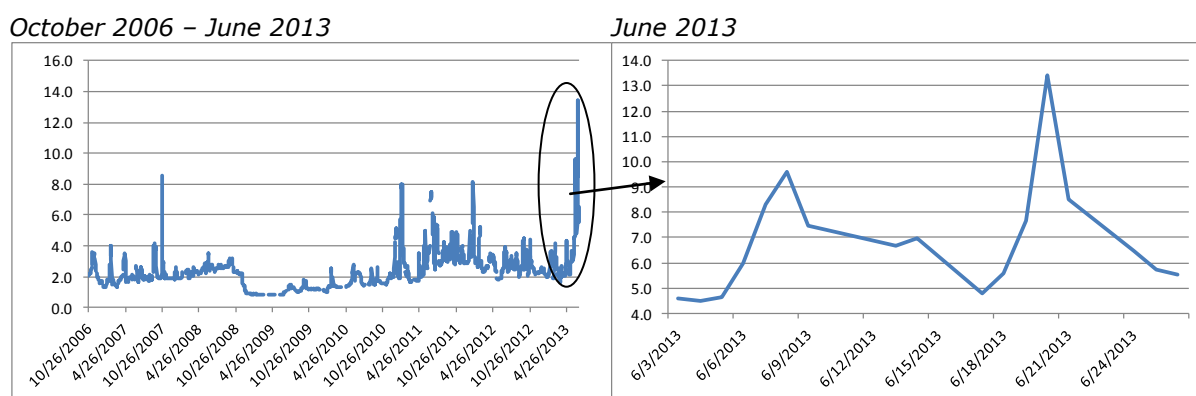
<sup>37</sup> *Economist*, "The Cheapest Thing Is Gone," June 15, 2013. <http://www.economist.com/news/china/21579488-after-enduring-decade-criticism-its-weakness-chinas-currency-now-looks-uncomfortably?frsc=dq%7Ca>.

<sup>38</sup> Agustino Fontevicchia, "China: Massive Credit Bubble Fueled By Shadow Banking and Securitization Could Collapse Banks," *Forbes*, June 17, 2013, via Factiva.

first week of the month, Agricultural Development Bank of China, one of China's "Big Four" commercial banks, raised just RMB 11.51 billion in a sale of six-month bonds, far less than its RMB 20 billion target. On June 14, China's Finance Ministry sold RMB 9.53 billion of 273-day bills, well below its RMB 15 billion target. That marked the first time in 23 months that MOF was unable to sell all of the debt offered at an auction.<sup>39</sup>

The situation further deteriorated in late June, when the cost of borrowing on the interbank market reached new highs.<sup>40</sup> Interbank lending rates skyrocketed and spiked on June 20, leading to a near standstill in interbank borrowing. The one-day repurchase rate increased by a record 5.27 percentage points, reaching an all-time high of 12.85 percent in Shanghai.<sup>41</sup> The Shanghai Interbank Offered Rate also spiked. On June 21, lending resumed among banks and financial institutions. Short-term interest rates fell sharply, but still remained higher than in early June, before they began their surge.

### Shanghai Interbank Offered Rate (Overnight)



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

The central government made no official announcement, and according to *The New York Times*, "it remained unclear whether policy makers had intervened."<sup>42</sup> On June 25, PBOC released a statement saying it had injected funds into some financial institutions in recent days to beef up their liquidity and said it could make similar moves in the future.<sup>43</sup> Hao Hong, chief China strategist at Bank of Communications, revealed to Bloomberg that the PBOC added \$8.2 billion to the financial system on June 20. Oddly, the sum was supplied to a single lender, assumed to be Industrial & Commercial Bank of China (ICBC), the largest of China's "Big Four" commercial banks. ICBC and PBOC refused to comment.<sup>44</sup>

Even as the cash crunch eased, some Chinese businesses have turned to bankers' acceptances, a type of short-term guarantee issued by banks to finance trade, to pay their

<sup>39</sup> Bloomberg, "China Debt Sale Fails for First Time in 23 Months on Cash Crunch," June 14, 2013. <http://www.reuters.com/article/2013/06/14/us-smithfield-results-idUSBRE95D0FD20130614>.

<sup>40</sup> Bloomberg, "China Debt Sale Fails for First Time in 23 Months on Cash Crunch," June 14, 2013. <http://www.reuters.com/article/2013/06/14/us-smithfield-results-idUSBRE95D0FD20130614>.

<sup>41</sup> Kyoungwha Kim and Fiona Li, "PBOC Said to Add Cash after China Money Rates Jump to Records," Bloomberg, June 20, 2013. <http://www.bloomberg.com/news/2013-06-20/china-money-rate-jumps-to-record-as-pboc-holds-off-on-cash-boost.html>.

<sup>42</sup> David Barboza, "China's Credit Squeeze Relaxes as Interest Rates Drop," *New York Times*, June 21, 2013. <http://www.nytimes.com/2013/06/22/business/global/chinas-bank-lending-crunch-eases.html>.

<sup>43</sup> Bob Davis and Lingling Wei, "China's Central Bank Acts on Cash Crunch," *Wall Street Journal*, June 26, 2013. <http://online.wsj.com/article/SB10001424127887323683504578566842205728724.html>.

<sup>44</sup> Kyoungwha Kim and Fiona Li, "PBOC Said to Add Cash after China Money Rates Jump to Records," Bloomberg, June 20, 2013. <http://www.bloomberg.com/news/2013-06-20/china-money-rate-jumps-to-record-as-pboc-holds-off-on-cash-boost.html>.



bills, according to a report in *The Wall Street Journal*.<sup>45</sup> Banks help facilitate commerce by issuing bankers' acceptance bills, which guarantee that companies will get paid when they deliver the goods they have agreed to produce at some future date. Since the bank promises to pay up regardless of who is holding the bill at maturity, they can pass through multiple hands as a substitute for cash.

The government has been largely silent on this issue, though Xinhua, a government mouthpiece, said the increase in money market rates was a result of market distortions caused by widespread speculative trading and shadow financing, confirming some analysts view that the cash crunch was the result of the central bank's attempt to tamp down nonbank lending, or shadow banking, which has boomed in recent years.<sup>46</sup> Other analysts blamed the cash crunch on foreign capital fleeing China. A monthly poll from Bank of America Merrill Lynch, published on June 18, showed that allocations to global emerging market equities in June hit their lowest level since December 2008. Investors became concerned about a potential economic shock in China, while demonstrating more confidence in the eurozone. The prospect of an end to the quantitative easing in the United States may have played a role as well.<sup>47</sup>

But a more important factor was China's government policy, which in the past has been capable of guiding financial markets. The central bank refused to inject sufficient liquidity into the financial system, adding a net RMB 92 billion to the financial system in mid-June, down from RMB 160 billion in the five days through June 7. Already in February, it stopped using reverse-repurchase agreements to inject funds.<sup>48</sup> The *Financial Times* went as far as to claim that the cash crunch was primarily politically motivated, in a move that had "echoes of Mao". Counter to requests by investors to lower interest rates in a flagging economy, the PBOC instead issued a statement on June 19 that "ordered a thorough implementation of the new 'mass line education' campaign launched this week by President Xi Jinping – a campaign that in its propaganda-style and potential scope carries echoes of the Mao era." In the order, Communist Party cadres running the central bank were told to attack the "four winds" of "formalism, bureaucracy, hedonism, and extravagance."<sup>49</sup>

The PBOC's austere approach followed earlier measures by the State Administration of Foreign Exchange, its subsidiary that handles China's foreign exchange reserves. SAFE issued a notice in early May outlining a set of measures aimed at controlling "hot money" and reducing foreign currency loans. SAFE pledged to more closely monitor firms' trade invoicing, and also imposed for the first time limits on net open positions held by Chinese banks with foreign-currency loan-deposit ratios exceeding 75 percent. The regulations took effect on June 1, both increasing the cost of borrowing and slowing the appreciation of the RMB.<sup>50</sup>

As Ting Lu, China economist at Bank of America Merrill Lynch, noted, the government's austere policy is risky – it could have its desired effect on reckless lenders but "will undoubtedly disrupt both the financial markets and the real economy if the liquidity squeeze

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<sup>45</sup> Dinny McMahon, "China Cash Crunch Spreads," *Wall Street Journal*, June 26, 2013.

<http://online.wsj.com/article/SB10001424127887323689204578569351878067378.html>.

<sup>46</sup> "Shadow Banking Behind China's Cash Crunch, Xinhua Says," Reuters, June 23, 2013.

<http://www.nytimes.com/2013/06/24/business/global/shadow-banking-behind-chinas-cash-crunch-xinhua-says.html?emc=tnt&tntemailQ=y&r=0>.

<sup>47</sup> Joe Dimmock, "Investors Back Away from Emerging Markets on China Fears: BofA Survey," Reuters, June 18, 2013. <http://www.reuters.com/article/2013/06/18/us-investment-bofa-survey-idUSBRE95H0JD20130618>.

<sup>48</sup> Bloomberg, "China Debt Sale Fails for First Time in 23 Months on Cash Crunch," June 14, 2013.

<http://www.reuters.com/article/2013/06/14/us-smithfield-results-idUSBRE95D0FD20130614>.

<sup>49</sup> Simon Rabinovitch, "Echoes of Mao in China Cash Crunch," *Financial Times*, June 20, 2013.

<http://www.ft.com/intl/cms/s/0/1c2f126c-d982-11e2-bab1-00144feab7de.html#axzz2WIOpOORi>.

<sup>50</sup> Zhang Monan, "China's Cold Eye on Hot Money," *Project Syndicate*, June 10, 2013. <http://www.project-syndicate.org/commentary/china-s-new-rules-for-managing-cross-border-capital-flows-by-zhang-monan>.

lasts too long.”<sup>51</sup> Fitch Ratings, a credit rating agency, noted: “Persistent tight liquidity conditions in China’s financial sector could constrain the ability of some banks to meet upcoming obligations on maturing wealth management products [WMPs] on a timely basis,” Fitch Ratings said in a report. WMPs are instruments sold to investors through banks and trust funds that are not accounted for in financial companies’ balance sheets.<sup>52</sup> Ironically, the cash crunch led many Chinese banks, hungry for liquidity, to accelerate sales of high-yield MVPs to customers rather than reining in risky lending.<sup>53</sup>

## **Energy Acquisition**

On June 6, the USCC held a hearing on China and the Middle East. Days earlier, the *New York Times* reported that China now buys nearly half the oil that Iraq produces, amounting to 1.5 million barrels per day (bpd), and is looking to further increase this share by bidding for a stake now owned by Exxon Mobil in one of Iraq’s largest oil fields. The agreement came as China increase its presence in Iraq. *The New York Times* reported that China had already built its own airport in the country to ferry workers to Iraq’s southern oil fields, and that there will soon be direct flights from Beijing and Shanghai to Baghdad. Some of the Chinese executives operating in the country speak fluent Arabic. Some experts argue that China’s engagement is not necessarily bad for U.S. interests, since it could help to grow and stabilize Iraq’s economy and boost global oil supplies, while not necessarily competing with U.S. companies, which are more focused on developing shale gas fields back home.<sup>54</sup>

China has also moved to ink more long-term oil contracts with oil exporters in developing countries. As reported in the USCC June trade bulletin, China Development Bank signed an oil-for-loans deal with India’s Essar in May.<sup>55</sup> Over the past month, this trend has continued. On June 20, the governments of Vietnam and China extended an agreement, first signed in 2006, to jointly explore for oil and gas in the Gulf of Tonkin. The original agreement expired this year, and has now been extended through 2016. The Gulf is located just north of the Paracel and Spratley islands, which have been at the heart of maritime territorial disputes between China and Vietnam. Many interest groups in Vietnam are also concerned about the country’s rising trade deficit with China. The original agreement, handled by state-owned Vietnam Oil & Gas Group (PetroVietnam) and China National Offshore Oil Corp (CNOOC), has been heralded as one of the few bright spots in increasingly tense relations. Commenting on why the pact is being extended, the Vietnamese government noted that “both sides have have built good cooperation and collected important data about oil and gas potential in the area which are in need of expansion now.”<sup>56</sup>

A day after the China-Vietnam agreement was announced, Russia’s Rosneft agreed to a \$270 billion deal to double its oil supplies to China. The firm will supply 300,000 bpd to China through 2025, on top of the 300,000 bpd it already ships. Russian President Vladimir Putin attended the signing of the agreement, and predicted that future shipments could even reach 900,000 bpd. For Russia, the deal is attractive because China is likely to pre-pay up to \$70 billion on the contracts (according to Putin), part of a total payment of \$270 billion. For Rosneft, which is laden with nearly \$40 billion in debt that is set to mature in

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<sup>51</sup> Neil Gough and David Barboza, “Credit Tightens in China as Central Takes a Hard Line,” *New York Times*, June 20, 2013. <http://www.nytimes.com/2013/06/21/business/global/china-manufacturing-contracts-to-lowest-level-in-9-months.html?pagewanted=2& r=0&ref=global>.

<sup>52</sup> David Barboza, “China’s Credit Squeeze Relaxes as Interest Rates Drop,” *New York Times*, June 21, 2013. <http://www.nytimes.com/2013/06/22/business/global/chinas-bank-lending-crunch-eases.html>.

<sup>53</sup> Bob Davis and Lingling Wei, “China’s Central Banks Acts on Cash Crunch,” *Wall Street Journal*, June 26, 2013. <http://online.wsj.com/article/SB10001424127887323683504578566842205728724.html>.

<sup>54</sup> Tim Arango and Clifford Krauss, “China Is Reaping Biggest Benefits of Iraq Oil Boom,” *New York Times*, June 2, 2013. <http://www.nytimes.com/2013/06/03/world/middleeast/china-reaps-biggest-benefits-of-iraq-oil-boom.html?pagewanted=all>.

<sup>55</sup> See the USCC March Trade Bulletin for a detailed analysis of China’s oil sector.

<sup>56</sup> Nguyen Pham Moi, “Vietnam, China to Extend Oil Project,” *Wall Street Journal*, June 20, 2013. <http://online.wsj.com/article/SB10001424127887324577904578556823670261056.html>.

2013-15, this cash injection solves these short-term financing problems. The company has frantically negotiated a series of smaller deals with other international buyers and creditors to deal with this problem. For China, in turn, the deal helps put the country's excess foreign exchange reserves of \$3.4 trillion to use, while likely allowing China to secure a stable, long-term price for the oil. Most of the oil will be Siberian crude supplied via a new pipeline opened in 2009. Some of this oil may be diverted from the European to the Chinese market.<sup>57</sup>

### ***China's Engagement in Africa and Latin America***

In June, China's deepening engagement with Africa and Latin America again came under scrutiny. On June 14, Reuters cited a document from Uganda's finance ministry indicating that China had agreed to co-finance a new hydropower dam on the Nile River. The 600 megawatt (MW) dam will begin construction by the end of this year. China is expected to account for \$500 million out of \$700 million in total financing. The deal is part of a broader Chinese investment drive in Uganda, primarily in telecoms, highways, and buildings. A possible motive for the investment is Uganda's newfound oil reserves, which are expected to come on line in 2017, likely with a portion exported to China.<sup>58</sup>

As labor costs in China rise, there are signs that its Africa interests are shifting to manufacturing. Huajian, one of China's largest shoe exporters, announced plans in early June for a multimillion-dollar factory expansion in Ethiopia, likely in order to benefit from preferential trade tariffs and lower labor costs. Huajian already employs 1,750 workers at the Ethiopian factory, and would add several hundred more. While some of the products are likely to go to other African consumer markets, the main target is the United States and Europe, which offer preferential tariffs for African exports. In this sense, Huajian's operations are a classic example of China's transshipping of manufactures through third countries to avoid trade barriers. Huajian is being sponsored by China's government through the China Africa Development Fund (CADF). Set up in 2006, CADF is a small quasi-sovereign wealth fund managed by China's policy bank, China Development Bank.<sup>59</sup>

A *New Yorker* article noted that China's share of Africa's exports jumped from one to 56 percent over the past decade. The question is whether those countries with deepening engagement have benefited in a broader sense – in Zambia, which exports copper and other minerals to China, unemployment and poverty are still pervasive. New legislation in Zambia now requires foreign investors to open and keep active taxable foreign-currency bank accounts, into which profits must be deposited within two months of shipping the goods abroad. That applies in particular to Chinese mine operators shipping goods back to China.<sup>60</sup> In February, Zambia revoked the mining license for a coal mine after workers rioted there in November and killed a Chinese manager. According to the country's Mines Minister Yamfwa Mukang, the mine, which is owned by a family of Chinese citizens, failed to comply with over 15 legal provisions.<sup>61</sup>

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<sup>57</sup> Denis Pinchuk, "Rosneft to Double Oil Flows to China in \$270 Billion Deal," Reuters, June 21, 2013. <http://www.reuters.com/article/2013/06/21/us-china-credit-idUSBRE95K0CM20130621>.

<sup>58</sup> Elias Biryabarema, "China Revives Uganda's Biggest Power Dam with \$500 Million Credit," Reuters, June 14, 2013. <http://www.reuters.com/article/2013/06/14/us-uganda-electricity-idUSBRE95D0EP20130614>.

<sup>59</sup> William Wallis, "China Plans Multimillion Ethiopia Investment," *Financial Times*, June 3, 2013. [http://www.ft.com/intl/cms/s/0/37011562-cc6d-11e2-9cf7-00144feab7de.html?ftcamp=published\\_links%2Frss%2Fworld\\_asia-pacific\\_china%2Ffeed%2F%2Fproduct#axzz2VACzJb5P](http://www.ft.com/intl/cms/s/0/37011562-cc6d-11e2-9cf7-00144feab7de.html?ftcamp=published_links%2Frss%2Fworld_asia-pacific_china%2Ffeed%2F%2Fproduct#axzz2VACzJb5P).

<sup>60</sup> Alexis Okeowo, "China in Africa: The New Imperialists?" *The New Yorker*, June 12, 2013. <http://www.newyorker.com/online/blogs/newsdesk/2013/06/china-zambia-resources-imperialism.html>.

<sup>61</sup> Bloomberg, "China's Africa Role under New Scrutiny as Miners Expelled," June 7, 2013. <http://www.bloomberg.com/news/2013-06-06/chinese-county-warns-locals-from-going-to-ghana-to-mine-for-gold.html>.

In Ghana, meanwhile, 166 Chinese nationals faced expulsion in early June for illegal gold mining and prostitution. According to Bloomberg, "The arrests highlight how thousands of ordinary Chinese have traveled to Africa in search of opportunity as China's state companies tap the continent's natural resources [...]." At the same time, the Chinese government declared Ghana unsafe as well. The Chinese county of Shanglin issued a warning against gold mining in Ghana and said it will help the miners return home by paying for their plane tickets. The justification, according to China's foreign ministry, was incidents in which Chinese personnel were robbed in Ghana's gold-mining sector.<sup>62</sup>

Botswana's central bank chief Ian Khama and Nigerian central bank chief Lamido Sanusi criticized China's engagement on the continent in recent months, complaining that China was acting in its own self-interest by exporting manufactures and importing resources.<sup>63</sup>

In Latin America, important shifts are occurring as well. In April, Glencore, a leading mining company, signed a deal with Beijing's Ministry of Commerce to begin the sale of assets in Las Bambas, a copper mine in Peru that is one of the group's largest projects. The company needs to secure a binding sale and purchase agreement by August of next year and transfer ownership by June 2015. Chinalco Mining Corp International and Hong Kong-listed MMG Ltd, both with links to Chinese SOEs, are considering offers for the mines, and are in talks with banks to make a bid worth around \$5 billion. Some market analysts suspect that Beijing's demand that the mine be sold was coordinated with these bids.<sup>64</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!](#)*

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<sup>62</sup> Bloomberg, "China's Africa Role under New Scrutiny as Miners Expelled," June 7, 2013.

<http://www.bloomberg.com/news/2013-06-06/chinese-county-warns-locals-from-going-to-ghana-to-mine-for-gold.html>.

<sup>63</sup> Bloomberg, "China's Africa Role under New Scrutiny as Miners Expelled," June 7, 2013.

<http://www.bloomberg.com/news/2013-06-06/chinese-county-warns-locals-from-going-to-ghana-to-mine-for-gold.html>.

<sup>64</sup> Denny Thomas, "Beijing's Forced Sale of Glencore Peru Mine May Play into China's Hands," Reuters, June 4, 2013. <http://www.reuters.com/article/2013/06/04/us-glencore-peru-idUSBRE95304U20130604>.