



U.S.-China Economic and Security Review Commission

Monthly Summary of U.S.-China Trade Data

May 3, 2013

Highlights of this month's edition

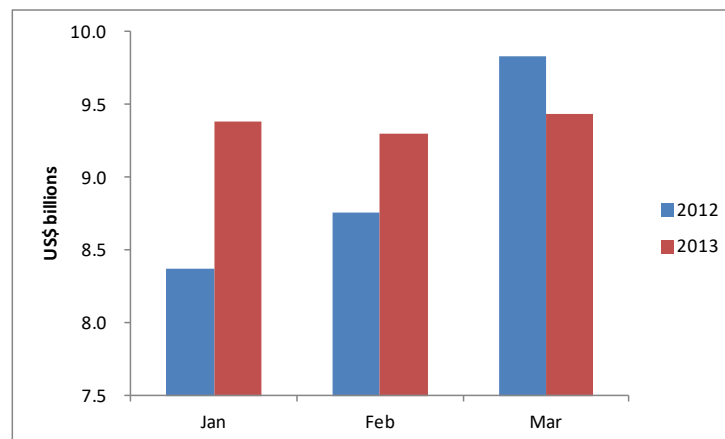
- **Bilateral trade:** Trade drops, but exports fare better than imports; higher value-added goods exports to China mark strong gains
- **Sector spotlight:** ATP exports to China grow and diversify; Services exports a major untapped opportunity; waste and scrap declines as a share of U.S. exports to China
- **China's economy:** Weak growth in first quarter amid flagging exports and low consumption; Fitch downgrades China's debt; RMB appreciates to highest level since 1994; foreign exchange accumulation resumes fast pace
- **Hearing spotlight:** The Commission will hold a hearing on May 9, 2013 to assess patterns of Chinese investment in the United States, the benefits and drawbacks of Chinese investment, and the mechanisms that exists in the United States to monitor and screen such investments.

The U.S. Balance of Trade with China

U.S. trade in goods with China dropped in March. Exports to China were four percent lower than a year ago after gains in January and February. At the end of March, cumulative, year-on-year growth in U.S. exports to China was 4.3 percent. At the end of February, the figure was 9.1 percent.

While March exports to China flagged, imports from China in March declined even more, falling 13 percent over last year. As a result, the trade deficit in goods with China actually fell by \$5.5 billion in March. While the deficit is still on pace to set a new record this year, the March figures suggest that it will increase by just 3 percent.

U.S. Exports to China, 2012 vs. 2013
(in US\$ billions)



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

Top Exports and Imports

All of the top-five U.S. imports from China registered strong declines in March, especially in miscellaneous manufactures and computer and electronic products. U.S. exports to China showed a more varied pattern. Although agricultural products and chemicals exports declined, transportation equipment, machinery, and computer and electronic products fared well.

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

U.S. Top-Five Exports to China				U.S. Top-Five Imports from China			
	Exports	Share of total (%)	Change over Mar'12 (%)		Imports	Share of total (%)	Change over Mar'12 (%)
<i>Monthly (March 2013)</i>				<i>Monthly (March 2013)</i>			
Transportation Equipment	1,745.9	18.5%	11.1%	Computer and Electronic Products	11,172.8	40.9%	-16.9%
Computer and Electronic Products	1,498.0	15.9%	31.1%	Electrical Equipment, Appliances, and Component	1,947.1	7.1%	-5.8%
Agricultural Products	1,108.0	11.7%	-34.5%	Miscellaneous Manufactured Commodities	1,797.5	6.6%	-17.3%
Chemicals	1,062.7	11.3%	-14.4%	Machinery, Except Electrical	1,744.4	6.4%	-10.8%
Machinery, Except Electrical	857.3	9.1%	6.1%	Apparel and Accessories	1,480.8	5.4%	-7.2%
Other	3,163.6	33.5%		Other	9,179.1	33.6%	
Total	9,435.4	100.0%		Total	27,321.7	100.0%	
<i>Year-to-date (thru March 2013)</i>				<i>Year-to-date (thru March 2013)</i>			
Agricultural Products	5,536.1	19.7%		Computer and Electronic Products	35,079.8	36.1%	
Transportation Equipment	4,396.8	15.6%		Miscellaneous Manufactured Commodities	7,514.0	7.7%	
Computer and Electronic Products	3,521.4	12.5%		Electrical Equipment, Appliances, and Component	7,051.3	7.3%	
Chemicals	3,069.2	10.9%		Apparel and Accessories	6,867.1	7.1%	
Machinery, Except Electrical	2,353.5	8.4%		Leather and Allied Products	6,001.0	6.2%	
Other	9,245.5	32.9%		Other	34,695.5	35.7%	
Total	28,122.6	100.0%		Total	97,208.7	100.0%	

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

USTR Balancing Act with China

Several actions by the U.S. Trade Representative (USTR) over the past month have illustrated the agency's delicate balancing act in managing relations with China. In early April, USTR General Counsel Tim Reif made remarks that indicated a conciliatory stance. He said that, while the USTR would hold China accountable for WTO violations, it would avoid litigation wherever possible. He referred to a "three-dimensional relationship" in which Washington and Beijing would work together toward common goals; that could also mean that the two countries will serve as co-complainants on certain cases, something they have not done so far. One example of this could be Argentina, where China and the United States have asked for a reduction in trade-restrictive measures.¹ Reif's remarks marked a clear

¹ "USTR Keeps Tough Line with China but Hopes for Increased Increased Cooperation," *Inside US-China Trade*, April 9, 2013. <http://chinatradeextra.com/Inside-US-China-Trade/Inside-US-China-Trade-04/10/2013/ustr-keeps-tough-line-with-china-but-hopes-for-increased-cooperation/menu-id-227.html>.

contrast to those of his colleague, USTR head Demetrios Marantis, who made critical remarks about China's forced technology transfer, currency manipulation, and intellectual property (IP) theft at a Senate Finance Committee hearing in late March.²

At a public briefing of its annual report on May 1, however, the USTR took a tougher stance. In particular, it reiterated criticism about China's theft of U.S. trade secrets. A USTR official said employee theft of trade secrets as well as cyber-theft is "a grave problem with dimensions that go beyond even trade and intellectual property issues."³

China's Foreign Direct Investment in the United States

On May 9, the USCC will hold a hearing on Chinese foreign direct investment (FDI) in the United States. According to official statistics, Chinese outbound foreign direct investment (FDI) set a record in 2012, reaching \$77.2 billion, up from \$60.1 in 2011. Energy was a key part of the portfolio: China National Offshore Oil Corporation (CNOOC), one of China's three national oil companies, made the largest investment in 2012, acquiring Canadian oil and gas producer Nexen for \$17.7 billion.⁴

Having been one of the world's largest recipients of FDI, China is slowly emerging as an FDI power in its own right. Outbound investment outpaced FDI inflows in 2012, thus reducing the country's net investment balance for the first time since 2009. According to the National Development and Reform Commission (NDRC), China's premier planning agency, this trend should continue in 2013. Outbound investment in the first two months of 2013 exceeded inbound FDI by nearly \$1 billion.⁵

Some argue that this is a sign of China's economic "rebalancing". On April 22, the State Administration of Foreign Exchange stated that only 30 percent of the offshore financial assets that China added to its portfolio in 2012 were in the form of U.S. treasuries and other reserves, much lower than the average level of 65 percent seen since 2004. The 30 percent figure is remarkably low considering that India holds 73 percent in reserve, and Korea, Russia, and Brazil all have a proportion over 40 percent.⁶ These trends indicate that China is using an increasing amount of its \$3.44 trillion in foreign exchange reserves for more equity investments abroad, as opposed to investments in government bonds.

² Testimony of Demetrios Marantis before the Senate Finance Committee Hearing on "The President's 2013 Trade Agenda," March 28, 2013.

³ For details, see our April trade bulletin. "China Trade Secret Theft a 'Grave Problem': U.S. Trade Agency," *Reuters*, May 1, 2013. <http://www.reuters.com/article/2013/05/01/us-usa-china-trade-idUSBRE9400JX20130501>.

⁴ "China's Foreign Investment Rebounds as Confidence Returns: Economy," *Bloomberg*, March 19, 2013. <http://www.bloomberg.com/news/2013-03-19/china-s-foreign-investment-gains-for-first-time-in-nine-months.html>.

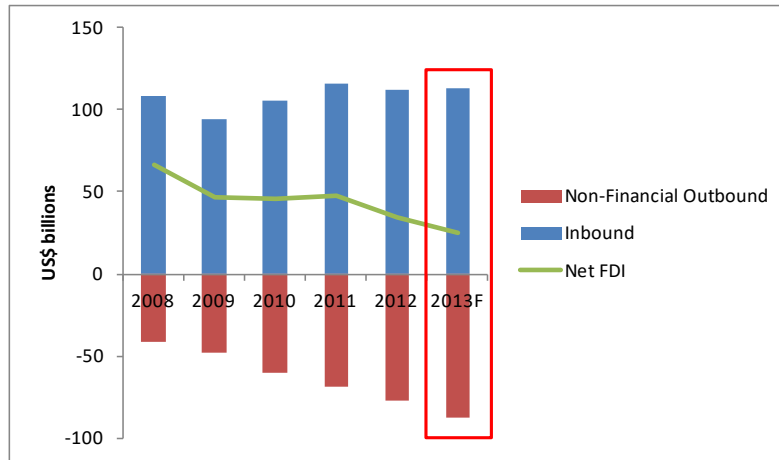
⁵ "China's Foreign Investment Rebounds as Confidence Returns: Economy," *Bloomberg*, March 19, 2013.

<http://www.bloomberg.com/news/2013-03-19/china-s-foreign-investment-gains-for-first-time-in-nine-months.html>.

⁶ Gao Changxin, "Offshore Financial Assets Improve," *People's Daily*, April 24, 2013.

<http://english.peopledaily.com.cn/90778/8220134.html>.

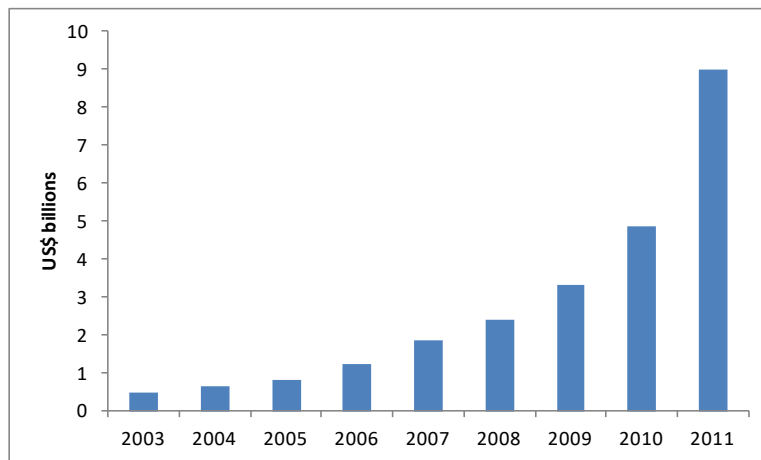
*Foreign Direct Investment In and Out of China:
Past Figures and Chinese Government Prediction for 2013*



Source: China Ministry of Commerce, via CEIC data; "China's Foreign Investment Rebounds as Confidence Returns: Economy," *Bloomberg*, March 19, 2013.
<http://www.bloomberg.com/news/2013-03-19/china-s-foreign-investment-gains-for-first-time-in-nine-months.html>.

Given the size of the bilateral trade relationship, and the magnitude of U.S. FDI in China, Chinese FDI in the United States remains undersized, especially in official government statistics. According to U.S. Bureau of Economic Analysis, the United States attracted \$174.7 billion in FDI in 2012, of which just \$219 million (less than 2 percent) came from China. Data on the stock of Chinese FDI in the United States shows a clear upward trend, though the overall amounts also remain small. China's official FDI data, released by the Ministry of Commerce (MOFCOM), has recorded much higher levels of Chinese investment in the United States. Its figures for 2012 have not been broken down yet by destination, though a MOFCOM spokesperson has indicated that the United States was among the top-three fastest growing destinations for Chinese FDI.

Chinese FDI in the United States, Stock, 2000-2011



Source: Ministry of Commerce of the People's Republic of China, *Statistical Bulletin of China's Outward Direct Investment*, various issues.

Both U.S. and Chinese official estimates are almost certainly too low. One key reason is that they do not account for flows of FDI through Hong Kong and other offshore financial centers, which are likely transit points on the way to the real investment destination. Notably, unofficial estimates put Chinese FDI in the United States much higher. Rhodium Group, a private U.S. consultancy that calculates Chinese FDI based on individual transactions, values Chinese investment in the United States at \$6.7 billion in 2012. Estimates for the first quarter of 2013 show that Chinese FDI is continuing its upward trajectory: Chinese firms completed eight M&A transactions and nine greenfield projects, together worth \$2.2 billion, with deals valued at over \$10 billion in the pipeline.⁷

In the composition of China's investment in the United States, energy, services, and high-end manufacturing stand out. Energy FDI accounts for two-fifths of FDI value, and is defined by a few major deals by state-owned energy giants. A key motive behind these energy investments is the pursuit of know-how and technology, particularly for fracking, an up-and-coming segment of the oil and gas market. China's national oil companies (NOCs) are using FDI not only to capture overseas energy resources, but also to enhance their competitiveness against Western oil companies.

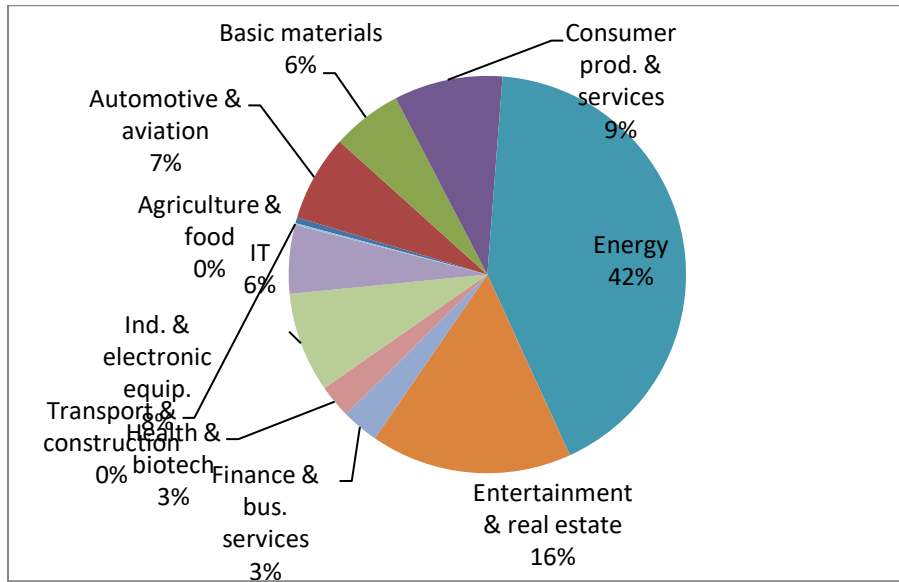
Services are also playing a major role, accounting for over a quarter of China's FDI value in the United States. In this segment, a burgeoning industry is real estate, which is a major market in China and favored by many Chinese investors as a more secure investment than equities. Industry data emerged in late April showing that Chinese companies and individuals had purchased \$3.89 billion worth of commercial real estate overseas in 2012, a 34 percent rise from the previous year. That figure may rise to \$5 billion this year, according to real estate-services group LaSalle, because a new law was introduced in October 2012 allowing Chinese insurance companies to invest overseas for the first time. Last year's purchases included major investments in U.S. cities, notably San Francisco, where China's largest developer China Vanke Co. partnered with U.S. real estate business Tishman Speyer Properties to build a \$620 million apartment downtown. (Under the deal, Vanke provides 70 percent equity, and Tishman is responsible for the construction.)⁸

High-end manufacturing is another important component of China's investments, particularly when measured in terms of the number rather than the value of deals. Industries such as IT and industrial equipment take top positions, reflecting Chinese interest in U.S. technology. Private investors are more likely to be involved in these smaller deals than state-owned enterprises. China's FDI in the United States thus illustrates the diversity of corporate ownership in China today.

⁷ Thilo Hanemann, "Chinese FDI in the United States: Q1 2013 Update," *China Investment Monitor*, April 30, 2013. <http://rhg.com/notes/chinese-fdi-in-the-united-states-q1-2013-update>.

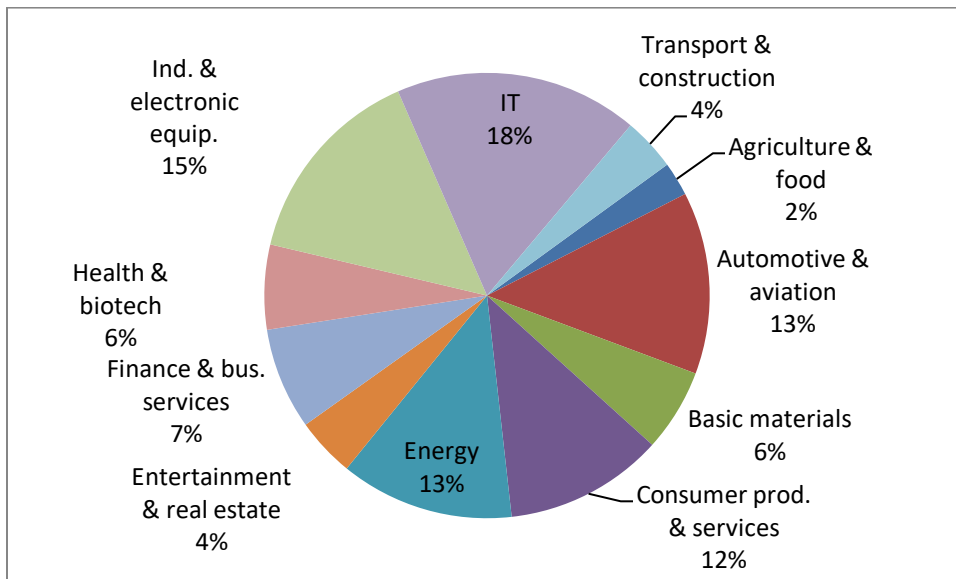
⁸ Richard Silk, "Chinese Investors Snap Up Commercial Properties," *The Wall Street Journal*, April 24, 2013. <http://online.wsj.com/article/SB10001424127887324474004578442590502077484.html#printMode>.

Cumulative Value of Chinese FDI in the United States, by Sector, 2000-2013Q1
 (Total deal value \$25.3 billion)



Source: China Investment Monitor, Rhodium Group

Cumulative Deals of Chinese FDI in the United States, by Sector, 2000-2013Q1
 (650 deals)



Source: China Investment Monitor, Rhodium Group

In spite of China's rising interest in the United States, some Chinese investors have recently expressed pessimism about the U.S. market. On April 23, a senior executive from China's telecoms giant Huawei stated that his company was no longer interested in the U.S. market

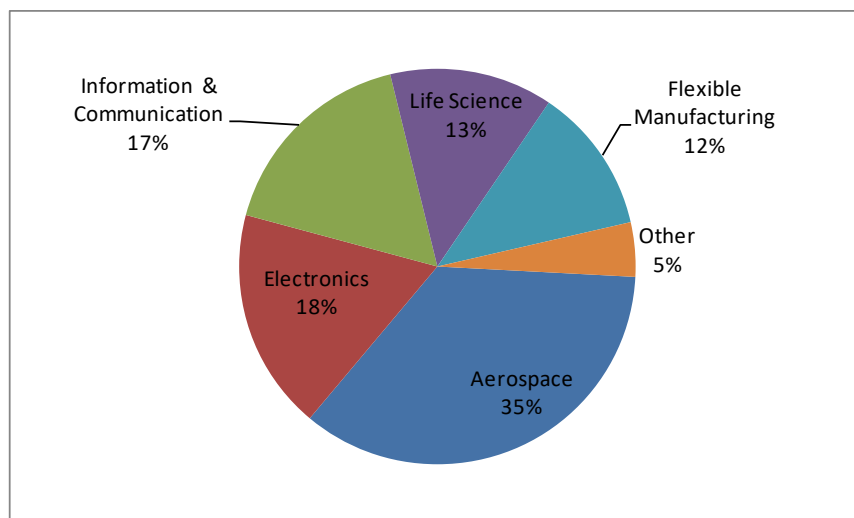
after failing repeatedly to sell its products to U.S. telecoms operators.⁹ The statements came roughly half a year after the House Intelligence Committee released a report highlighting the security risks of buying equipment from Huawei.¹⁰ Similar frustration was voiced by Gao Xiqing, the head of China Investment Corp. (CIC), China’s flagship sovereign wealth fund, during a visit to Washington on April 25. He expressed frustration that his fund was being “singled out as a different investor” by the U.S. authorities, going as far as to say that certain people were “slapping [us] in the face and telling [us], OK, we don’t like you.”¹¹ Gao’s displeasure is noteworthy, given CIC’s major investments in U.S. finance and energy companies, including Blackstone, Morgan Stanley, AES, and Chesapeake Energy.

Sector Spotlight

Advanced Technology Product Trade

The U.S. trade deficit with China in advanced technology products (ATP) has declined so far this year by \$1.2 billion. That is a positive development, even though the overall deficit in ATP products remains high at \$25.7 billion. Further, U.S. ATP exports to China continue to diversify. Flexible manufacturing and life sciences increased their share of ATP exports by 7 percent and 4 percent respectively over last year. Meanwhile, China’s ATP exports to the United States remain heavily concentrated in IT and electronics.

*Composition of U.S. ATP Exports to China through March 2013
(Total value \$5.8 billion)*

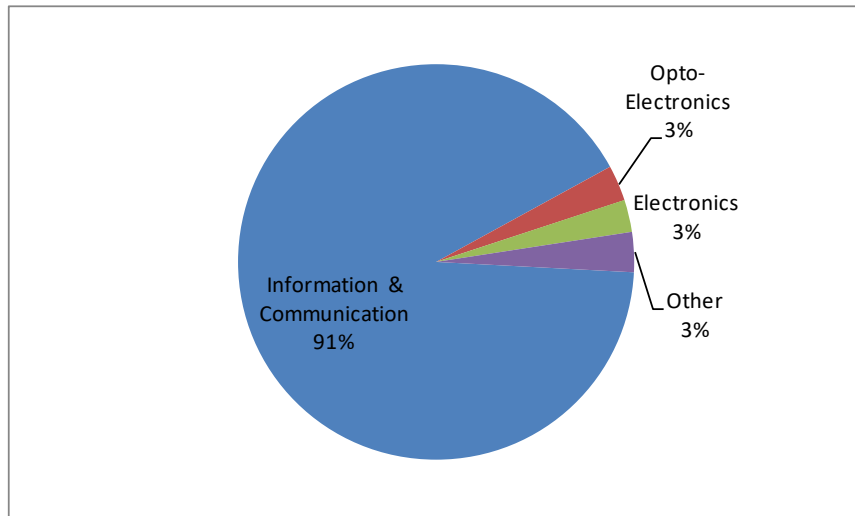


⁹ “You Can’t Fire Me, I Quit,” *The Economist*, April 24, 2013. <http://www.economist.com/blogs/schumpeter/2013/04/telecoms>.

¹⁰ For a copy of the report, visit [http://intelligence.house.gov/sites/intelligence.house.gov/files/documents/Huawei-ZTE%20Investigative%20Report%20\(FINAL\).pdf](http://intelligence.house.gov/sites/intelligence.house.gov/files/documents/Huawei-ZTE%20Investigative%20Report%20(FINAL).pdf).

¹¹ Kasia Klimasinska, “CIC Chief Gao Says China’s Fund Treated Differently by U.S.,” *Bloomberg Businessweek*, April 25, 2013. <http://www.businessweek.com/news/2013-04-25/cic-chief-gao-says-china-s-fund-treated-differently-by-u-dot-s-do>.

*Composition of U.S. ATP Imports from China through March 2013
(Total value \$31.4 billion)*



Source: U.S. Census Bureau, *U.S. Trade with China in Advanced Technology Products - Monthly and Cumulative Data* (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, May 2013). <http://www.census.gov/foreign-trade/statistics/product/atp/2012/11/ctryatp/atp5700.html>.

Services Trade

Services accounted for 29 percent of U.S. exports in 2012, versus just 16 percent of imports. The services trade surplus has helped mitigate the United States' massive goods deficit with the world; in 2012, services shaved \$17 billion of the U.S. trade deficit. In the first two months of this year, services already achieved a \$35 billion surplus, \$5 billion higher than at the same point last year.

Although China is better known as a goods exporter, its services exports have picked up as well over time. The discrepancy between the world's two largest economies is still large – U.S. services exports were three times as large as China's in 2011. However, since 2005, China has increased its share of world services exports by 0.8 percent, whereas the U.S. share has declined by 0.4 percent.

Services Exports: China, the United States, and the World
(US\$ billions)

	2005	2006	2007	2008	2009	2010	2011	CAGR
<i>US\$ billion</i>								
World	2,552.3	2,890.3	3,463.3	3,892.8	3,501.0	3,824.6	4,254.7	8.9%
China	88.7	113.3	147.0	165.3	143.2	170.5	184.0	12.9%
United States	360.8	400.2	468.2	514.7	489.2	533.1	583.3	8.3%
<i>Share of world (%)</i>								
United States	14.1%	13.8%	13.5%	13.2%	14.0%	13.9%	13.7%	
China	3.5%	3.9%	4.2%	4.2%	4.1%	4.5%	4.3%	

Source: World Bank. <http://data.worldbank.org/indicator/>

In both countries, there is significant potential to further expand services trade, which as a share of GDP remains well below the world and European Union average.

Trade in Services as a share of GDP, 2005-2011
(%)

	2005	2006	2007	2008	2009	2010	2011
World	11.0%	11.4%	12.1%	12.4%	11.8%	11.9%	11.9%
European Union	16.5%	17.2%	17.7%	18.3%	18.3%	19.0%	19.4%
United States	5.4%	5.7%	6.1%	6.6%	6.4%	6.6%	6.9%
China	7.7%	7.9%	8.0%	7.2%	6.1%	6.2%	5.8%

Source: World Bank. <http://data.worldbank.org/indicator/>.

Although bilateral services trade data is only available through 2011, there is strong evidence that U.S. services exports to China have picked up, especially since the global financial crisis. In 2005-11, China doubled its share of U.S. services exports, vaulting from 11th to 4th among U.S. service export partners. The compound annual growth of these exports in 2001-2011 was 16.4 percent, versus just 7.7 percent for U.S. services exports to the world. Meanwhile, U.S. imports of services from China, which primarily comprise services related to goods, such as freight and transport, have not increased much over time, further expanding the U.S. trade surplus in services with China.

China and the World's Share of U.S. Services Exports

		2001	2003	2005	2007	2009	2011
U.S. service exports (US\$ billions)	World	278.1	295.3	376.7	492.6	512.1	607.7
	China	5.4	5.7	8.4	13.0	15.9	26.7
U.S. exports to China as share of total	Share (%)	1.9%	1.9%	2.2%	2.6%	3.1%	4.4%
	Rank	11	12	9	7	7	4

Source: OECD.

Nonetheless, at \$27 billion in 2011, China was still far behind the United States' top-three export partners in services, Canada (\$56 billion), the UK (\$53 billion), and Japan (\$45

billion). This low share likely is due to weak IP protection in China, a heavily regulated financial sector, and an underdeveloped consumer economy.

The Waste and Scrap Sector

Over the past year, an important but subtle change has occurred in the composition of U.S. exports to China. For the first time, waste and scrap is no longer among the top-five exports to China. It has been overtaken by higher value-added products, such as machinery and chemicals. That is a notable change, given that a third of the waste and scrap traded in the world flows from the United States to China.

Beginning in the mid-1990s, China's sharp increase in imports of scrap and waste provided a lucrative business for many U.S. and Chinese scrap and waste dealers. Scrap metal exports from the U.S. soared due to China's demand for inexpensive steel and copper to fuel rapid infrastructure development.¹²

Paper waste from the United States has also been in high demand in China, and many Chinese entrepreneurs have made fortunes in this business. Zhang Yin was named by Forbes in 2006 as the wealthiest woman in China after her company, Nine Dragons Paper (Holdings) Limited, became the leader in importing U.S. paper waste. Once it arrives there, it is used to produce a variety of low-grade paper products. Nine Dragons is now the largest containerboard producer in Asia.¹³

Electronics waste, or "e-waste", has also been a top U.S. export to China. In 1991, China adopted the Basel Convention, a United Nations treaty to prevent the transfer of hazardous waste to less developed countries. (The United States has not ratified the U.N. treaty.) However, despite joining the U.N. treaty and other domestic regulations prohibiting the import of e-waste, China in 2012 accounted for 70 per cent of the world's e-waste imports. Due to the value of metals such as gold, silver, and platinum used in certain electronics products, smuggling e-waste into China remains highly profitable.¹⁴ China's relatively low labor costs have also given China a comparative advantage in recycling such waste. At the same time, China's less sophisticated recycling facilities produce more harmful waste in comparison to facilities in developed countries.¹⁵

Waste and scrap has long been one of the top U.S. exports to China. In 2012, waste and scrap was the sixth-largest U.S. export to China, accounting for eight percent of the total. Since China's accession to the WTO, China has increased its share of U.S. waste and scrap exports by over 10 per cent, and accounted for over a third of all U.S. waste and scrap exports in 2012. Back in 2000, the revenue earned from waste and scrap exports to China was just \$744 million, less than what the United States shipped to Canada. By 2011, the figure was \$11.5 billion.

¹² "China's Need for Metal Keeps U.S. Scrap Dealers Scrounging," *The New York Times*, March 13, 2004. Retrieved from <http://www.nytimes.com/2004/03/13/business/china-s-need-for-metal-keeps-us-scrap-dealers-scrounging.html?pagewanted=all&src=pm>

¹³ "China's 'Queen of Trash' finds riches in waste paper," *International Herald Tribune*, January 15, 2007. Retrieved from <http://www.nytimes.com/2007/01/15/business/worldbusiness/15iht-trash.4211783.html>

¹⁴ "70% of annual global e-waste dumped in China," China Association of Environmental Protection Industry (CAEPI), May 25, 2012. Retrieved from <http://english.chinaenvironment.org/article/10000042.htm>

¹⁵ "A cadmium lining," *The Economist*, January 26, 2013. Retrieved from <http://www.economist.com/news/international/21570678-growing-mounds-electronic-scrap-can-mean-profits-or-scandals-cadmium-lining>

However, in 2012, waste and scrap exports began to slow, dipping to \$9.5 billion. Based on the first three months of this year, these exports should fall further to about \$9 billion this year. There are several potential causes behind this decline. One is that China's slowing economy has decreased demand for scrap and waste materials, much of which are recycled into infrastructure projects. The slowdown in the global economy has also reduced global scrap metal prices, so that the same volume of waste and scrap now commands a lower value.¹⁶

The Chinese government may also be doing more to regulate waste and scrap trade in order to mitigate its harm to health and the environment. The Chinese government tightened scrap and waste import regulations under new "Solid Waste Import Regulations" implemented in August 2011. The regulations require importers to obtain certification before importing solid waste and increased customs supervision requirements.¹⁷ China's plastic waste imports have also been affected due to stricter import regulations implemented in 2011.¹⁸ In addition, the government has launched "crackdowns" on forbidden and restricted wastes. During a recent crackdown in Shanghai, customs officials seized 383 containers of imported foreign waste that was judged to be in violation of Chinese regulations.¹⁹

In the long-run, structural shifts in China's economy will likely lead to a continual reduction in demand for waste and scrap. China's labor pool is shrinking, so that workers are demanding higher wages and better working conditions. Those demands run counter to the needs of many companies in the waste and scrap business. A slowdown in infrastructure projects, as China shifts to a more consumer-led economy, should also reduce demand for metals scrap.

China's Economy

In mid-April, China announced that its GDP growth for the first quarter of 2013 was 7.7 percent. That was 0.2 percent lower than in the fourth quarter of 2012 – and far lower than many experts had forecast. In a poll of economists, both AFP news agency and *Bloomberg* had produced a forecast of around 8.0 percent.²⁰

¹⁶ "China's Doldrums Put Pressure on U.S. Exporters," *The New York Times*, October 22, 2012. Retrieved from http://www.nytimes.com/2012/10/23/business/global/chinas-slowing-economy-puts-pressure-on-american-exporters.html?pagewanted=all&_r=0

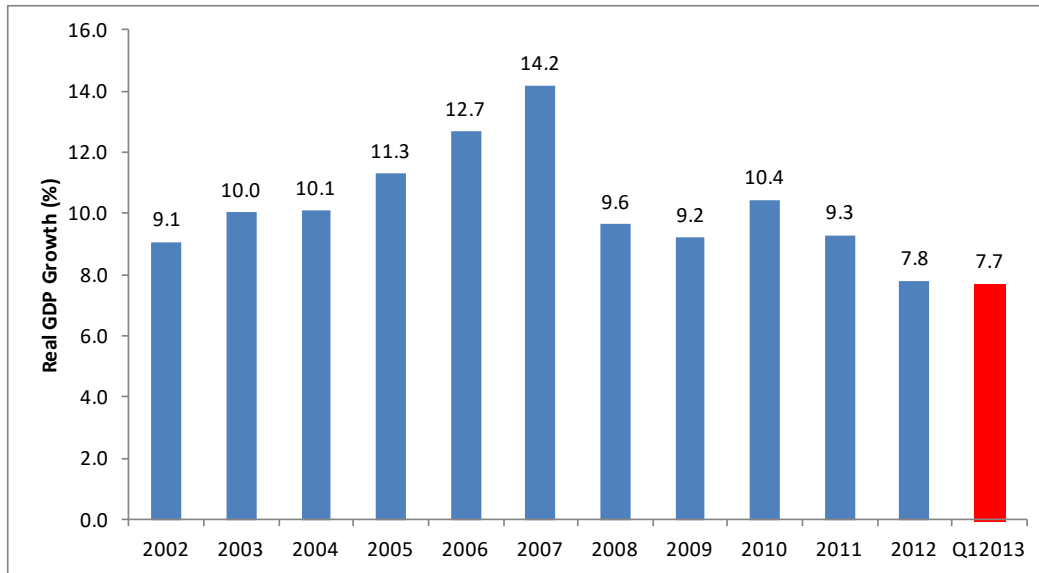
¹⁷ "China tightens supervision over solid waste import," *Xinhua*, June 29, 2011. Retrieved from http://www.chinadaily.com.cn/china/2011-06/29/content_12804617.htm

¹⁸ "Waste plastic imports drop as China gets tough with recyclers," *Waste & Recycling News*, January 11, 2013. Retrieved from <http://www.wasterecyclingnews.com/article/20130111/NEWS02/130109937/waste-plastic-imports-drop-as-china-gets-tough-with-recyclers>

¹⁹ "Shanghai seizes 6,000 tonnes of foreign waste," *Xinhua*, April 11, 2013. Retrieved from http://news.xinhuanet.com/english/china/2013-04/11/c_132301916.htm

²⁰ "China Economic Growth Lower than Forecast," *Al Jazeera*, April 15, 2013. <http://www.aljazeera.com/news/asia-pacific/2013/04/201341581348240446.html>; "China Industrial Profit Growth Slows as Economic Recovery Wanes," *Bloomberg News*, April 28, 2013. <http://www.bloomberg.com/news/2013-04-27/china-jan-march-industrial-companies-profit-rises-12-1-.html>.

China's Real GDP Growth (%)



Source: National Bureau of Statistics, via CEIC data.

Subsequently, many experts revised their growth projections for China. J.P. Morgan cut China's economic growth estimate for 2013 from 8.2 percent to 7.8 percent.²¹ *The Economist* remained more optimistic, predicting 8.4 percent growth for 2013.²² The International Monetary Fund (IMF) and World Bank also produced contradictory projections. The IMF predicted that China would grow by 8.0 percent instead of 8.3 percent this year, but maintained that growth over the next few years would still average 8.0 to 8.5 percent annually.²³ The World Bank's chief Asia economist predicted the inverse: growth of 8.3 percent this year, but a slowdown to "between 6 and 7 per cent by the end of the decade".²⁴

Trade and Consumption

China's exports had a very weak month in March, counter to strong export growth in January and February. Growth was slightly better than a year earlier, but that did not mean much, because 2012 marked China's weakest economic growth in 13 years. It was also far behind the breakneck export growth of 2010 and 2011.

²¹ "JP Morgan Cuts China 2013 GDP View to 7.8%," *The Wall Street Journal Market Watch*, April 15, 2013. http://articles.marketwatch.com/2013-04-15/economy/38535314_1_china-economy-official-data-economic-growth-estimate

²² "Economic and Financial Indicators," *The Economist*, April 20, 2013, p.96.

²³ James T. Areddy and Tom Orlik, "Slower China Growth Signals Days of Miracles Are Warning," *The Wall Street Journal*, April 15, 2013. <http://online.wsj.com/article/SB10001424127887324345804578424490978181424.html>.

²⁴ Jamil Anderlini, "China Enters Era of Low Growth," *Financial Times*, April 15, 2013. <http://www.ft.com/intl/cms/s/0/99552806-a5ae-11e2-b7dc-00144feabdc0.html#axzz2QXhiYuNr>.

China's Exports in March: Year-on-Year Growth (%)

	2009	2010	2011	2012	2013
Monthly	-17.1%	24.2%	35.8%	8.8%	10.0%
Cumulative	-19.7%	28.7%	26.4%	7.6%	18.3%

Source: China's General Administration of Customs, via CEIC data.

Exports to the EU are likely to perform as poorly this year as they did last year. It is noteworthy that exports in recent years have been stronger in the first quarter than for the year as a whole; based on this trend, this year could see below 1 percent growth in China's exports to the EU. According to a new report, Euro-area services and manufacturing output contracted for a 15th month in April as the currency bloc remained mired in recession.²⁵

Annual Growth of China's Exports to the EU

		2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Value (US\$ bn)	Ytd March	9.9	14.1	20.0	31.1	37.5	51.6	64.0	49.9	65.4	76.6	75.2	76.0
	Year	48.2	72.1	104.6	143.8	181.9	245.2	293.0	236.3	311.3	356.1	334.1	na
Yoy Growth (%)	Ytd March	1.2%	42.2%	41.7%	55.4%	20.5%	37.4%	24.1%	-22.1%	31.0%	17.1%	-1.8%	1.1%
	Year	17.6%	49.6%	45.1%	37.5%	26.6%	34.8%	19.5%	-19.3%	31.7%	14.4%	-6.2%	na

Source: China's General Administration of Customs, via CEIC data.

EU and North America as a Share of Chinese Exports



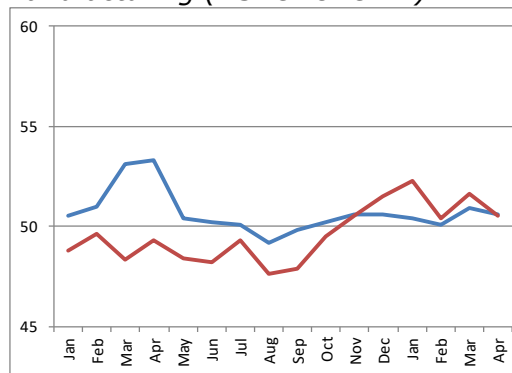
Source: China's General Administration of Customs, via CEIC data.

²⁵ "China's Recovery Falters as Manufacturing Growth Cools," *Bloomberg*, April 23, 2013. <http://www.bloomberg.com/news/print/2013-04-23/china-s-manufacturing-growth-slows-as-economic-recovery-falters.html>.

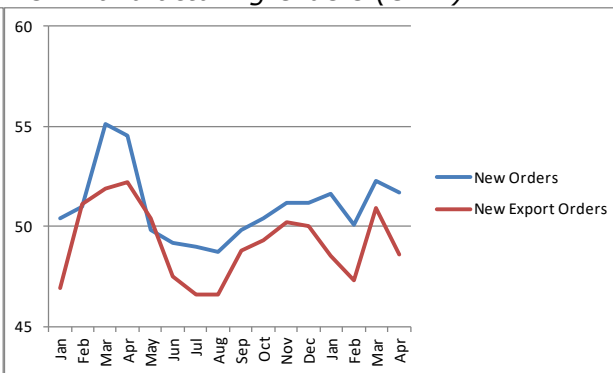
Producer sentiment for the months ahead is also not positive. The optimism of many producers in March dissipated in April, especially in regard to export orders.

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

Manufacturing (HSBC vs. CFLP)



New Manufacturing Orders (CFLP)



Source: China's National Bureau of Statistics, via CEIC data; HSBC Purchasing Managers' Index. <http://www.hsbc.com/1/2/emerging-markets/em-index/purchasing-managers-index>.
Note: HSBC PMI is based on early "flash" reading. Subsequent reading may differ slightly.

In a further blow to market sentiment, China's government revealed in April that its export numbers for the end of 2012 were inaccurate. On April 10, a spokesman from the statistics department at the General Administration of Customs, the Chinese agency in charge of compiling trade data, acknowledged serious errors in his agency's official trade data that had significantly overstated exports.²⁶ Subsequently, on April 25, the government released a revised version of the current account balance for 2012, in which the balance in the fourth quarter of the year was \$21 billion lower than previously stated. The government did not make any adjustments to the current account for the first three quarters of 2012; as such, the annual balance was reduced from \$214 billion to \$193 billion. The lower current account surplus indicates that the rebound in exports was weaker than the government claimed. The acknowledgment vindicated many market observers, who had cried foul about China's export numbers already months ago. The government's exaggeration of export figures may continue into 2013: gains in overseas shipments exceeded Bloomberg's forecasts by at least 7.5 percentage points in December, January and February, the first time that this has happened in three straight months in eight years.²⁷

Flagging exports are not being offset by more domestic consumption. Retail sales growth in March slid to 12.6 percent year on year, down from 15.2 percent at the end of 2012.²⁸ A key factor dampening consumption is the new leadership's effort to restrain excessive

²⁶ A day later, the same official also acknowledged that, during the April 10 press conference, he had also provided "incorrect" and "groundless" information that the National Development and Reform Commission, the nation's top economic planning agency, had approved about 7 trillion RMB of investment projects in the fourth quarter of 2012. He argued in his defense that the information had come from the internet rather than the NDRC itself. "China Customs Official Apologizes for Incorrect Investment Data," *Bloomberg News*, April 11, 2013. <http://www.bloomberg.com/news/2013-04-11/china-customs-official-apologizes-for-incorrect-investment-data.html>.

²⁷ "China Export-Data Skepticism from Goldman to Nomura," *Bloomberg News*, April 9, 2013. <http://www.bloomberg.com/news/2013-04-08/china-export-data-skepticism-deepens-from-goldman-to-nomura.html>.

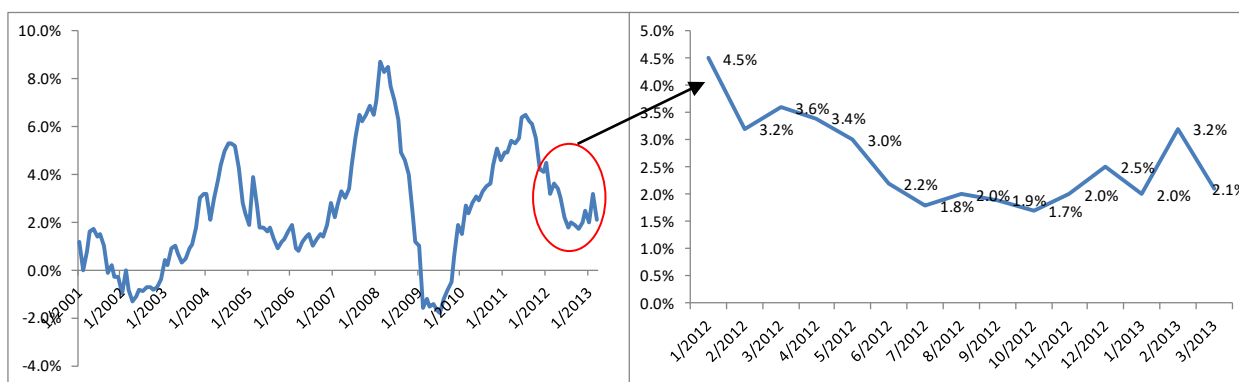
²⁸ James T. Areddy and Tom Orlik, "Slower China Growth Signals Days of Miracles Are Warning," *The Wall Street Journal*, April 15, 2013. <http://online.wsj.com/article/SB10001424127887324345804578424490978181424.html>.

spending among government officials. For the first time since the 1980s, for example, banquet revenues fell during the Spring Festival season at the beginning of the year, according to the Chinese Cuisine Association. The government plans to offset this drop by increasing social spending, so that households may be encouraged to save less. So far, however, this policy has had little noticeable effect.²⁹

Stability in the Financial Sector

Inflation in March continued to hold steady at 2.1 percent, a far cry from the high inflation rates of 2008 and 2011. Concerns about inflation when the central bank cut interest rates last summer have not been substantiated.

*Inflation in China (Consumer Price Index)
(%)*



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

In addition, local governments have taken important steps to cool the housing market. The Beijing government took drastic action in March: a 20 percent tax on used home transactions; a ban on owning two homes in the city; and down payment requirements for second-home buyers raised from 60 percent to 70 percent. As a result, in early April, pre-owned home transactions declined by as much as 70 percent.³⁰

Stable inflation has also boosted international confidence in the Chinese currency, which is both appreciating and becoming more available internationally. On April 25, the RMB hit its highest level against the U.S. dollar since the currency system was consolidated in 1994.³¹ China has come under pressure from the U.S. government to liberalize its exchange rate regime. Currently, the regime is still very tight: the spot rate is still only allowed to diverge from the daily fixed rate by 1 percent.³²

On April 25, the government in Hong Kong loosened restrictions on interbank trading of the RMB. The move is intended to enhance Hong Kong's status as an offshore RMB trading

²⁹ James T. Areddy and Tom Orlik, "Slower China Growth Signals Days of Miracles Are Warning," *The Wall Street Journal*, April 15, 2013. <http://online.wsj.com/article/SB10001424127887324345804578424490978181424.html>.

³⁰ "With New Anti-Bubble Rules, Housing Sales Collapse 70 Percent in Beijing," *Forbes*, April 9, 2013. <http://www.forbes.com/sites/kenrapoza/2013/04/09/with-new-anti-bubble-rules-housing-sales-collapse-70-in-beijing/>.

³¹ Fiona Law and Carol Chan, "Hong Kong RMB Market Steps Forward," *The Wall Street Journal*, April 25, 2013. <http://online.wsj.com/article/SB10001424127887324474004578444131690895340.html#printMode>.

³² Fiona Li, "RMB Jumps to 19-Year High on PBOC Fixing, Rising Global Usage," *Bloomberg*, April 25, 2013.

center, a segment that is witnessing competition from the likes of London, Singapore, and Taiwan.³³ The move was also significant, because it added to other forms of RMB use recently put in place. The RMB is increasingly used as an invoicing and settlement currency, as global RMB payments increased 33 percent month-on-month in March, ranking the currency 13th in international payments.³⁴ Within financial markets, the RMB has primarily been used for offshore RMB bonds.³⁵

In spite of low inflation and confidence in the RMB, China's domestic economy continues to struggle with high debt levels incurred since the government launched a stimulus in 2009, during the global financial crisis. According to *The Wall Street Journal*, debt among firms and households rose from 138 percent to 201 percent of GDP in the first quarter of 2013. Most of that debt still appears to be in the corporate sector, which historically has borrowed the excess savings of households.³⁶ Debt is also high among local governments, who have become highly leveraged by issuing bonds based on the expectation of rising land values. Swiss bank UBS estimates government debt at around 60 percent of GDP.³⁷

On April 9, the markets were shaken when Fitch Ratings downgraded China's long-term local currency debt from AA- to A+. Notably, Fitch's rating is at odds with that of fellow rating agencies Moody's and Standard & Poor's, who both upgraded their views on China's economy in late 2010, based on the assumption that China has a very strong ability to repay its debts. To justify the downgrade, Fitch cited "underlying structural weaknesses" in the Chinese economy, including low average incomes, lagging governance standards, as well as excessive debt levels. Fitch also warned that shadow banking was becoming a major concern, stating that "the proliferation of other forms of credit beyond bank lending is a source of growing risk from a financial stability perspective."³⁸

UBS estimates China's shadow banking system at 45 percent of GDP (\$3.4 trillion). Many individuals and businesses borrow from private lenders because they lack necessary collateral and can't pay the extremely high interest rates and fees charged by the state-owned banks, which can be up to 4 times as high as the interest rate. According to one estimate, only about 3 percent of China's small and medium-sized companies borrow from banks. Due to weak performance in the stock market and China's slower economic growth, many small businesses are having trouble paying back loans within the shadow banking system. There has been a six-fold increase in private lending lawsuits in Wenzhou, a hub of private lending in Zhejiang province.³⁹ The concern is that this shadow lending system, especially mutual funds, is leading to too much debt on company balance sheets. Because such investments are not regulated, many institutions offload securities to other actors in the market for a certain period, even as the original owner still earns the interest payments

³³ Fiona Law and Carol Chan, "Hong Kong RMB Market Steps Forward," *The Wall Street Journal*, April 25, 2013. <http://online.wsj.com/article/SB10001424127887324474004578444131690895340.html#printMode>.

³⁴ Fiona Li, "RMB Jumps to 19-Year High on PBOC Fixing, Rising Global Usage," *Bloomberg*, April 25, 2013.

³⁵ Fiona Law and Carol Chan, "Hong Kong RMB Market Steps Forward," *The Wall Street Journal*, April 25, 2013. <http://online.wsj.com/article/SB10001424127887324474004578444131690895340.html#printMode>.

³⁶ Tom Orlik, "China Assets May Offset Debt Worries," *The Wall Street Journal*, April 25, 2013.

<http://online.wsj.com/article/SB10001424127887324474004578444200030104488.html>.

³⁷ Tom Orlik, "China Assets May Offset Debt Worries," *The Wall Street Journal*, April 25, 2013.

<http://online.wsj.com/article/SB10001424127887324474004578444200030104488.html>.

³⁸ Josh Noble and Simon Rabinovitch, "Fitch Downgrades China's Credit Rating," *Financial Times*, April 9, 2013.

<http://www.ft.com/cms/s/0/591224c8-a0ff-11e2-bae1-00144feabdc0.html>.

³⁹ Jun Luo, "Regulating China's Shadow Banking System Isn't Easy," *Bloomberg Businessweek*, April 25, 2013.

<http://www.businessweek.com/articles/2013-04-25/regulating-chinas-shadow-banking-system-isnt-easy>.

and price gains from the bonds. That leads to potential insider trading, and may disguise actual debt levels.⁴⁰

China's Foreign Exchange Reserves "Back to Normal"

On April 25, China unveiled its current account balance for the first quarter of 2013, with several important implications. For one, foreign exchange accumulation was again very strong (\$157 billion), higher than all of last year put together (\$97 billion). Further, the ratio of the current account surplus to foreign exchange reserve growth is back to where it was in 2011 – foreign exchange reserves grew by three times as much as the current account in the first quarter, as opposed to last year, where the current account surplus was nearly twice as high as the foreign exchange growth.

A plausible explanation for what is happening is in the financial and capital account – money is coming back into the country after China's once-in-a-decade leadership transition was finalized in March. Many public officials and other wealthy individuals, fearing recriminations and anti-corruption campaigns, are rumored to have funneled money out of the country in 2012, leading to a huge drop in foreign exchange accumulation. Some \$79 billion of foreign exchange outflows went unaccounted for by the central bank. Now that the leadership transition is over, it is possible that some of this money is flowing back into the country.

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 or [join the Commission on Facebook!](#)

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⁴⁰ "Probe Risk Sends AAA Spreads to Three-Month High: China Credit," *Bloomberg*, April 25, 2013. <http://www.bloomberg.com/news/2013-04-26/probe-risk-sends-aaa-spreads-to-three-month-high-china-credit.html>.