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S. HRG. 114–367

EVALUATING THE FINANCIAL RISKS OF CHINA

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

SECOND SESSION

ON

EXPLORING THE CURRENT STATE OF THE CHINESE ECONOMY AND THE POTENTIAL FINANCIAL RISKS IT MAY POSE TO THE UNITED STATES

JULY 14, 2016

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.fdsys.gov/

U.S. GOVERNMENT PUBLISHING OFFICE

45–417 PDF WASHINGTON : 2023

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EVALUATING THE FINANCIAL RISKS OF CHINA

THURSDAY, JULY 14, 2016

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:01 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Richard C. Shelby, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The Committee will come to order.

Today the Committee will hear testimony on the Chinese economy and the risks it may pose to the United States. This hearing comes at a pivotal time, following last month's Strategic and Economic Dialogue between the United States and China and prior to the G–20 Summit in September.

China is currently seeking recognition by the World Trade Organization as a "market" economy rather than as a "nonmarket" economy. China is the United States' largest trading partner, and it has the largest banking sector in the world. An economic downturn in China could have a serious negative impact on American jobs and businesses.

The numbers speak for themselves: In 2015, the United States imported $482 billion of total goods from China, and China imported more than $116 billion in total goods from the United States. In 2014, Americans invested almost $66 billion in China, compared to just $9.5 billion of Chinese direct investment in the United States.

And, of course, China is the largest foreign holder of U.S. debt. And although our economic relationship with China is significant, experts argue that China has not followed through on its commitments to the United States, such as enhancing fair trade policies, providing greater investor protections, and securing intellectual property rights.

Rather than encouraging free trade and competition, China's recent reforms appear to protect industries it considers to be strategically important.

On the one hand, China's tilt toward free market capitalism has lifted many millions of its citizens out of poverty. In addition, since China began its free market reforms in 1978, the economy has grown 70 times larger.

On the other hand, China still has a long way to go. And despite the success of some free market reforms, the Chinese government

still plays a dominant role in the economy, either through its direct management of state-owned enterprises or its dictates from the central government.

In its Third Plenum of 2013, the Chinese government committed to allowing the free market to play a greater role in the economy in order to "rebalance" away from investment and export-driven growth and toward greater domestic consumption.

Many question the Chinese government's commitment to change, however. American businesses and investors recognize a variety of risks in the Chinese economy such as its slowing growth, volatile financial markets, currency policies, potential capital outflows, and aggressive pursuit of U.S. intellectual property.

Some believe that China's economic stimulus following the 2008 financial crisis has left the financial system with an unusually high percentage of bad debts. China's total public and private debt has almost doubled from 150 percent of GDP in 2007 to nearly 300 percent today.

Last year, the imbalances created by China's debt-fueled economic stimulus resulted in a stock market crash and an overnight devaluation, which caused many to rethink China's ability to maintain its high economic growth rates.

These are just a few illustrations of China's risky policies that could lead to future crises. I look forward today to hearing from our panel of experts regarding the current state of the Chinese economy and the potential risks it may pose to the United States.

Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman, for holding today's important hearing.

China's economy by some measures is larger than the U.S. economy and is very influential in global markets. But China's economic growth is slowing. As a result, China continues to make decisions to boost its economy, even when those decisions are not good for long-term stability and even when they violate international trade rules. American businesses and American workers suffer as a result.

Implicit in this discussion is an acknowledgment that the promises made 15 years ago by the People's Republic of China and supporters of that country joining the World Trade Organization, majorities in both Houses, in this body and across the hall, have gone unfulfilled. China has not transitioned to a market economy; it has not lived up to the commitments it made when it joined the World Trade Organization.

Instead of pursuing industrial policies that boost the Communist Party, China needs to make structural economic reforms that are good for domestic and global economic stability.

For example, China needs to "rebalance" its economy. Instead of adding more production capacity, which has triggered massive overcapacity problems in the global markets—we know what that does to us—the Chinese government needs to increase domestic consumption and move to a more service-based economy to allow for more sustainable growth for their country.

China should also reduce state ownership and state control in its economy. China has used state-owned enterprises to implement its industrial policies, but the consequences are sectors defined by overcapacity, by inefficiencies, by corruption, and in far too many cases by excess.

A presumption of government support has allowed unprofitable and poorly managed Chinese companies to issue debt cheaply and add industrial capacity. Servicing this debt is getting harder as profits decline and defaults rise. According to the International Monetary Fund, total loans potentially at risk on Chinese commercial banks' balance sheets at the end of 2015 were estimated to be about $1.3 trillion, some 15.5 percent of the total.

These loans are not just a risk for the Chinese government. They present a risk to global financial stability as well.

We need to watch for an uptick in acquisitions of U.S. firms by Chinese state-owned enterprises that could pose national security concerns for our country. And we cannot ignore the fact that China has regularly intervened in its currency exchange rate to boost exports to the detriment of American manufacturers. While the yuan has appreciated in value recently, we know that we are just one decision away from a currency intervention that will hurt our business and workers. We know what that does, especially to States like Indiana, Pennsylvania, and Ohio.

It is very difficult for American companies to compete with a nonmarket economy that undervalues its currency when it wants, uses state ownership to support companies that would otherwise fail, contributes to global overcapacity in major sectors, and follows the rules only when it suits its interests.

It is also hard to compete against a country with persistent human rights abuses. A group of Ohioans came to see me at my office today from Falun Gong, talked about all the issues and human rights abuses that have been aimed at them and others. It is hard to compete against a country with discrimination like that against religious minorities, with weak labor and environmental standards, with state-sponsored cyber espionage, and intellectual property theft.

If any industry knows the harm that China's nonmarket economy and policies can pose to our country, it is the steel industry and Senator Donnelly's Indiana and Senator Toomey's Pennsylvania and my State of Ohio. Our steel sector has experienced firsthand the consequences of China's industrial policies and competing against that country's state-owned enterprises.

There is a crisis among U.S. steel manufacturers, some 14,000 steel workers have been laid off. The crisis gets worse as China attempts yet again to export its way out of its problems, out of a slowdown.

This is why I invited Tom Gibson, President and CEO of the American Iron and Steel Institute, to testify today. Steel workers understand the impact, his companies understand the impact, their workers understand the impact and risks of China's policies.

That is why this hearing is so important. American companies and workers need a level playing field, not xenophobia and not cynical China-bashing. I will never do that. Finding real solutions to push China to change its economic policies, in fact, is the key.

Thank you.

Chairman SHELBY. First, we will receive testimony from the Honorable Dennis Shea, who is the Chairman of the U.S.-China Economic and Security Review Commission and who is no stranger to this Committee.

Next, we will hear from Dr. Desmond Lachman, who is a Resident Fellow at the American Enterprise Institute.

Then we will hear from Mr. Thomas Gibson, who is the President and Chief Executive Officer of the American Iron and Steel Institute.

Last, we will receive testimony from Dr. William Wilson, who is a Senior Research Fellow at the Heritage Foundation.

All of your written testimonies will be made part of the record in its entirety. We will start with you, Mr. Shea.

STATEMENT OF DENNIS C. SHEA, CHAIRMAN, U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Mr. SHEA. Well, thank you, Mr. Chairman, Ranking Member Brown, and Members of the Committee, for this opportunity to testify today. Before I begin, I would like to make a disclaimer that this testimony reflects my personal views and not necessarily the judgments of the U.S.-China Commission.

Today I will focus my remarks on state control in China's economy and implications for the United States. Since I will be summarizing the key points of my written testimony, I refer it to you for fuller treatment of these issues.

First, it is important to understand the extent of the state's role in China's economy. The Chinese government props up its state-owned enterprises, also called "SOEs," and designated private firms while limiting market access for U.S. and other foreign firms through strict market entry criteria, opaque regulations, compulsory joint ventures, and China-specific technical standards. These policies create an uneven playing field that disadvantages U.S. companies both in China and abroad.

Under President Xi Jinping, the government is redoubling efforts to increase its control over private and public companies in key industries. Despite repeated pledges to let the market play a "decisive role" in resource allocation, Beijing continues to use SOEs as a tool to pursue social, industrial, and foreign policy objectives. These efforts are evident in China's economic reform plans, which seek to help SOEs become "bigger and stronger," not reduce the size of the state sector.

The government's influence extends not just to SOEs but also to private companies. This is an important point. In testimony before the Commission earlier this year, University of Florida professor Wentong Zheng stated that "the hallmark of Chinese state capitalism is an ecosystem in which the government is at the center of the economy and everybody else caters to the government's needs." In this ecosystem, public and private managers alike are incentivized to foster close ties with the government.

Beijing primarily seeks to maintain control of strategic sectors that advance the state's political and economic interests. Economically strategic sectors, such as industrial producers, enable the government to support short-term economic growth, while politically

sensitive sectors, such as telecommunications, are essential to the government's goals of advancing and controlling China's technology infrastructure and disseminating information.

With Beijing's policies creating an unfair competitive environment both inside and outside of China, the relationship between SOEs and foreign companies in China has become particularly tense. One challenge U.S. businesses face in China is navigating the country's regulatory environment. U.S. investors have little to no recourse to protect their rights or fairly resolve disputes under China's opaque legal system.

The regulatory challenges U.S. businesses face in China appear to be getting worse. According to a 2016 American Chamber of Commerce survey, 77 percent of U.S. companies reported they felt foreign businesses are less welcome in China than before.

Market access restrictions also continue to limit the ability of U.S. companies to invest in China. China restricts foreign investment in many sectors where the United States maintains a competitive advantage in order to protect domestic companies and industry. In general, fluctuations in China's foreign investment restrictions follow a pattern where, at first, the government welcomes FDI into sectors deemed strategic for its national economic development in order to extract technology, IP, and know-how from foreign firms. However, after the domestic industry is judged sufficiently developed, Beijing issues new policies restricting investment to push out foreign companies and free up the market for domestic firms.

Furthermore, China's government is introducing policies aimed to replace established market leaders with domestic firms. The Chinese government's latest blueprint for the economy, the 13th Five-Year Plan, designates sectors such as semiconductors, biomedicines, cloud computing, mobile Internet, and ecommerce for additional government support. These policies seek to break China's dependence on imports from foreign producers in sectors where the United States currently enjoys a technical advantage.

Beijing, as you mentioned, Mr. Chairman, is pursuing a "going out" policy which encourages domestic companies to invest abroad through policy directives and subsidization. As a result, Chinese investment abroad, and particularly in the United States, has spiked. Many Chinese companies investing abroad receive support from state banks and capital markets in return for advancing state goals. And overall Chinese foreign investment is focused primarily in strategic sectors.

I know my time is running out. If you give me 30 seconds, I will finish up.

China has benefited tremendously from past economic liberalization and its close trading relationship with the United States. These are not abstract concepts: Witness China's massive trade surpluses, rising outward FDI, and burgeoning soft power. Several decades of economic prosperity have also fueled China's rapid military modernization and growing strategic assertiveness, most evident in the territorial disputes in the South China Sea and East China Sea.

Today China's leadership seems to have forgotten the critical role economic reform has played in China's own success story, and,

unfortunately, it seems that the Xi administration is tightening the grip on the Chinese economy, not letting market forces play a more significant role.

I thank you for the opportunity to testify.

Chairman SHELBY. Dr. Lachman.

STATEMENT OF DESMOND LACHMAN, PH.D., RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. LACHMAN. Thank you, Chairman Shelby, Ranking Member Brown, and Members of the Committee, for affording me the honor of testifying before you today. I would like to make two basic points.

The first is that China's economic growth model appears to have run its course, and China would now seem to be headed for many years of very slow economic growth, much as occurred to Japan before it.

The second point I would like to make is that developments in the Chinese economy can have a material impact on the United States' economic outlook. This would not be so much directly through China's impact on U.S. exports; rather, it would be indirectly through the impact that China could have on the global economy and on global financial markets.

Allow me to elaborate on these two points.

There are several reasons for concern right now about the Chinese economic outlook. The first is that since 2008 China has had a massive credit bubble that has been among the fastest on historical record. This has seen credit increase at a faster pace than that occurred before Japan's lost decade in the 1990s and before the U.S. housing bust in 2007. This has given rise to a massive degree of excess capacity in steel and construction as well as to bubbles in Chinese equity and property markets. This heightens the risk that the Chinese banking system will become increasingly clogged with nonperforming loans and with loans to zombie public sector enterprises, very much along the lines that occurred in Japan over the past two decades.

Second, the unwinding of China's credit and asset price bubbles will be occurring at a highly inauspicious time for the global economy. Major economies like that of the United Kingdom, Italy, Brazil, and Japan are all likely to experience meaningful economic slowdowns in the period ahead, and it is important that we do not just look at China in isolation.

Third, China has very poor long-run demographics as a result of its one-child policy, and its government appears to be stalling on the long-run reforms that the country so desperately needs to increase productivity.

Finally, any further appreciation of the U.S. dollar could induce the Chinese to resort to currency depreciation. This risks again precipitating capital outflows out of China and harming trade relations with the United States. As far as the implications for the United States economy, as I mentioned, the direct impact of a slowing in the Chinese economy would not have a material effect on the U.S. economy. After all, China only accounts for around 7 percent of total U.S. exports or less than 1 percent of U.S. GDP. The way in which the U.S. economy could be materially affected by further

slowing of the Chinese economy is indirectly through the effect that such a slowing might have on the rest of the world economy and on global financial markets. This might occur through three distinct channels.

First, a slowing in the Chinese economy would have a significant impact on the exports of China's Asian trading partners and of countries like Germany, which are very much more dependent than is the United States on the Chinese export market.

Second, China might be forced to make use of the exchange rate to bolster its flagging economy, especially if it continues to suffer from capital outflows. This could result in tensions in global currency markets where all too many countries are today seeking to cheapen their currencies through unorthodox monetary policy. That would risk unsettling global financial markets.

Finally, a slowing of the Chinese economy must be expected to keep international commodity prices low for a protracted period of time. This has the potential to deepen the political and economic crisis already being experienced in commodity-exporting emerging market countries like Brazil, Russia, and South Africa.

For these reasons, it would appear to me to be a mistake for U.S. policymakers to minimize the impact that a setback in the Chinese economy could have for the U.S. economy.

Chairman SHELBY. Thank you.

Mr. Gibson.

STATEMENT OF THOMAS J. GIBSON, PRESIDENT AND CEO, AMERICAN IRON AND STEEL INSTITUTE

Mr. GIBSON. Thank you, Mr. Chairman, Ranking Member Brown, for having me here. AISI represents integrated and electric arc furnace steelmakers with facilities in 41 States, Canada, and Mexico.

I am not going to talk so much about the macroeconomic risks—those are going to be well covered by others—as much as consequences. The American steel industry has been severely impacted by the surge in dumped and subsidized imports into our markets. Finished steel imports took a record 29 percent of the U.S. market in 2015, while domestic steel shipments declined by over 12 percent, and capacity utilization averaged just 70 percent for the year. Several steelmakers have been forced to temporarily close facilities, including mills in Fairfield, Alabama; Ashland, Kentucky; Granite City, Illinois; as well as iron ore mines in Minnesota. BLS data indicates that the steel industry employment has declined by nearly 14,000 jobs since January 2015.

This import surge results from foreign government interventionist policies, chiefly China, that have fueled massive global overcapacity in steel. That is estimated by OECD to be about 700 million metric tons today. More than half of that, 425 million metric tons, is located in China where government market-distorting policies have dramatically increased the size of its industry so that today it represents half of all global steel production.

After many years of growth, Chinese steel demand has declined over the last 2 years and is expected to drop further over the coming decade. As a result, China's steel industry has increasingly relied on exports to consume its surplus, with Chinese steel exports rising to 112 million metric tons in 2015. That is more than the 96

million metric tons of steel consumed in the United States last year. This has led to increased imports of dumped and subsidized Chinese steel in the United States and elsewhere. In addition, Chinese steel exports to third countries are being processed into steel products that are then exported to the United States.

China's dramatic increase in capacity has occurred despite financial returns that are well below those returned by other global steel industries and, in fact, even other industries in China. China's major steel firms reportedly lost more than $15.5 billion last year alone, and many believe the actual figures are much greater.

Nine of the 10 largest steel producers in China are state-owned, and the top two producers produced more steel in 2014 than the entire U.S. steel industry. Unlike market-based companies, Chinese companies can run these massive debts because the Chinese government will often direct state-owned banks to continually refinance the debt and ultimately sweep it off the books and into asset management companies or other state-created financial devices or firms designed to absorb bad corporate debts and cover the losses.

As we have already heard, another way China distorts international trade is by controlling the exchange rate between its currency and the dollar, and I think the other testimony has covered the risk of renewed depreciation of China's currency *vis-a-vis* the dollar in the future.

We appreciate the changes that Congress made in the recently enacted Trade Facilitation and Trade Enforcement Act on currency reporting, but AISI believes the U.S. Government can and should take much more aggressive action on currency. Congress should act now on the Currency Undervaluation Investigation Act, which would explicitly treat currency manipulation as actionable under U.S. trade laws, and it has been championed by Senators Brown, Schumer, Sessions, Portman, and others.

We also recommend the following policy actions to address the global steel overcapacity crisis:

First, vigorously enforce the trade laws. It is essential that the U.S. Government use all means available under the trade laws, including fully utilizing the improvements made to these laws by Congress last year in the Leveling the Playing Field Act. Customs and Border Protection should also use all the tools made available to it under the recently enacted ENFORCE Act to prevent evasion of AD/CVD orders on steel products.

Second, the Administration must also continue to treat China as a nonmarket economy for antidumping purposes. Prematurely granting China market economy status would completely undermine the effectiveness of our trade laws.

Third, the Administration should seek binding commitments by all major steelmaking nations to eliminate current market-distorting subsidy programs specific to the steel sector and refrain from introducing new subsidy programs in the future.

Fourth, the Administration should press for binding commitments from China and other countries to eliminate excess capacity resulting from government market-distorting policies and practices.

And, finally, Congress should impose a strict prohibition on multilateral and export bank lending on steel projects, which has been

a significant source of funding for unnecessary capacity survival and expansions.

Thank you, Mr. Chairman, for your attention, and I look forward to answering your questions.

Chairman SHELBY. Dr. Wilson.

STATEMENT OF WILLIAM T. WILSON, PH.D., SENIOR RESEARCH FELLOW, THE HERITAGE FOUNDATION

Mr. WILSON. Good morning. My name is Bill Wilson. I am an Economist, a Senior Research Fellow at the Heritage Foundation. And although I have spoken many times in public over the past quarter century, this is my first time in front of a congressional Committee. I appreciate the Chairman for inviting me today.

I lived abroad for 7 years. I lived for 4 years recently in Beijing. And when I arrived last year, my colleagues asked me whether I had ever testified on the Hill, and I replied, "What hill?"

[Laughter.]

Mr. WILSON. And they laughed, not knowing that I did not actually know. But it is a pleasure to be here.

Again, the views I may express may not necessarily reflect the official position of the Heritage Foundation. I am going to keep my comments extremely brief, maybe about 3 minutes, keeping time for questions.

In short, China, in my opinion, is in trouble. There is a cancer in the economy, and it has metastasized. Recently, headline figures have conveniently matched Beijing's target figures of 6.5 to 7 percent. Here is an economy with 1.4 billion people, and they released GDP figures 14 days after the end of the quarter, and there are no revisions.

There are plenty of inconsistencies. While GDP was reported as 6.8 percent in 2015, electricity consumption rose by only a half a percent. These two figures are simply not consistent.

As Chairman Shelby had mentioned in his earlier comments, if you look at China's total debt—I am talking about household, corporate, government debt, including provincial debate—it is now much higher than in other developing economies and actually comparable to levels in the United States and the eurozone which have much higher levels of a stock of wealth.

Where the concern, though, is, what is more troubling is the speed at which debt has accumulated. It was approximately 150 percent of GDP in 2007, a year before the crisis, and now it ranges between close to 300 percent of GDP. These are enormous figures.

Since the 2008–09 global recession, China has accounted for roughly one-third of global economic growth, by far the highest in the world. With a gross domestic product of roughly $100 trillion, measured at market prices, the second largest economy in the world after the United States, any economic slowdown in this Asian juggernaut is bound to have global economic consequences.

Since 2010, the rate of economic growth in China has decelerated from 9.3 percent in 2011 to a reported 6.8 percent in 2015. And the accuracy of this latest figure is in serious question.

I will finish by saying the question is: What is the impact of a further slowdown in China on the U.S. economy? There are three primary channels in which a significant slowdown in China could

impact the U.S. economy. The first, of course, is through trade. In 2015, China was America's third largest export market after Canada and Mexico, respectively. The value was $116 billion. Exports to China accounted for about 7.7 percent of total U.S. exports in 2015, not an inconsequential figure but not devastating to U.S. export revenue in the event of a further stall in Chinese growth.

The second, of course, is financial. As also Chairman Shelby mentioned, the Chinese, as of the latest figure, April 2016, replaced the Japanese as the largest holder of U.S. debt, at $1.2 trillion.

In the event of a further slowdown in the Chinese economy, the government may want to sell some of these securities for economic stimulus. This could lead to a fall, of course, in U.S. bond prices—*i.e.,* a rise in U.S. interest rates. This impact has been discussed extensively and largely exaggerated for two reasons. First, the Chinese are unlikely to liquidate a large portion of their U.S. Treasury holdings because it might lead to a capital loss on their existing holdings. Second, U.S. Treasuries are the most liquid and most coveted securities in the world.

I know I am running out of time. Give me 15 more seconds.

Chairman SHELBY. Take your time.

Mr. WILSON. And the last channel is largely a positive one. The slowdown in the Chinese economy has significantly depressed global commodity prices. Despite the shale revolution that we have witnessed the past 5 years, the United States imported 9.4 million barrels of petroleum per day in 2015. So the net impact for the U.S. economy was positive.

I will finish here.

Chairman SHELBY. Thank you.

I will start with you, Dr. Lachman. In your testimony, you say that China's pace of credit expansion in recent years, which you refer to as a "credit bubble," exceeds those that have preceded other major crises like the Asian financial crisis and the U.S. housing crisis. A couple of questions here.

Is it possible that this credit bubble will lead to a financial crisis in China? And what would be the potential impact on the U.S. economy? Dr. Wilson alluded to it a minute ago.

Mr. LACHMAN. The credit bubble in China has no precedent elsewhere. This is far larger than it has been in many other countries, and those countries that have had those sort of bubbles have all run into deep trouble.

Now, there are two kinds of trouble that countries can run into. One is you can have a financial crisis like we had in the United States with Lehman spreading through the global economy. The other—and that I think is the more likely outcome—is you can have a Japanese situation in which, because you have got real problems in the financial sector, the economy becomes highly sclerotic. It gets clogged with loans who prop up some big companies, and it really just loses its dynamism.

My belief is that China is going to go the second course, the Japanese course, mainly because China's economy is very different from that of a regular economy in that the state controls both the banks and it controls the state enterprises. So what it is likely to do in the event that there is somewhat of a meltdown is they will

instruct the banks, as they seem to be doing now, to continue lending to these companies, to continue piling up the debt.

So I do not expect to see a sharp disruption in China, but I do expect to see China's economy slowing. And as I mentioned, one has to be viewing that in the context of the rest of the world. Europe does not look healthy. Japan does not look healthy. A number of major commodity-producing countries do not look healthy. To have China slowing could just add to a global environment that is not very helpful to the United States.

Chairman SHELBY. Thank you.

Dr. Wilson, you described China's level of debt as "unprecedented and unsustainable." Explain that. And what are the potential dangers of such high levels of debt?

Mr. WILSON. Yes, if the last 7 or 8 years have taught us anything in the United States, it is, you know, the consequences of excessive leverage. If you look at the U.S. GDP numbers, the U.S. economy, because of the excess leverage that we experienced over the last 15 years, has grown—the U.S. economy has grown less than 3 percent for 9 consecutive years as a result of deleveraging. If you go back to the Bureau of Economic Analysis and look at the numbers and go way back to the Great Depression, you will not find a period of such slow protracted growth.

I know this: I worked as a banker, as a bank economist, for 9 years, and the economic stimulus package that Beijing passed in 2009 was a mother of all stimulus packages. It amounted to 20 percent of gross domestic product. I know this as a banker: If you lend out that much capital over a short period of time, most of the loans will go sour. There is no doubt about it.

Chairman SHELBY. It is throwing money at a problem, isn't it?

Mr. WILSON. Exactly. That is what you do. The CCP, the Chinese Communist Party, their major concern, of course, is maintaining power. There is a *quid pro quo.* They deliver the goods—that is, growth in excess of 7 percent, full employment, in excess. The Chinese give up, you know, political freedom. That contract could expire very shortly.

How fast is the Chinese economy growing? I do not know exactly. We do not have reliable figures. But it is not 6.8 percent. It is probably more in the range of 4.5, 5 percent. And so this is not a sustainable equilibrium.

Do the Chinese have further room to add debt? They do. They do. They could leverage up to 400 percent of GDP over the next 2 to 3 years. But after that, time expires. It is not a sustainable equilibrium.

Chairman SHELBY. How do you deleverage something like that? Isn't that a question? If you are up to 400 percent, if you got that high, then you are going to have to deleverage that someday, aren't you?

Mr. WILSON. Yeah, as a former banker, people say, well you just write off debt. Well, if you write off—you simply do not write off debt. Someone pays for it. Either the lender or the borrower or, increasingly, the taxpayer pays for that writeoff. It does not disappear. It does not disappear from the balance sheet.

Chairman SHELBY. It is consequences, isn't it?

Mr. WILSON. Exactly.

Chairman SHELBY. Currency devaluation, we have talked about that here, too. A recent article in The *Economist* magazine noted, and I will quote, that "A mere 2 percent devaluation of the yuan last summer sent global stock markets crashing; a bigger bust would do far worse."

Is it possible that an economic downturn in China could lead to similar events in the future? And what would be the impact on the United States? Dr. Lachman, I will pose that to you. I know I am not picking on you.

Mr. LACHMAN. I think that the risk of another currency move in China is very real. That is not simply because what you are getting in terms of a slowing Chinese economy, that they might need to use that to get a further leg up on the export competition that they are so good at. But it is rather because what another devaluation can do, is it can really cause capital to leave China.

Now, the reason that one has to be concerned that China might resort to this is that the dollar could very well appreciate, as it is doing right now, because you have had Brexit and stuff of that sort. As the dollar appreciates, the Chinese might want to depreciate their currency against the dollar, and that is, in fact, what we have been seeing the last couple of weeks.

So one really cannot exclude that China is again going to be depreciating its currency, not necessarily against a basket of all currencies but certainly against the U.S. dollar in the context of the U.S. dollar strengthening, and that can have consequences like *The Economist* noted. Last August, we saw ripples going right through the global financial system because of a 2-percent move in the Chinese currency. So one really cannot exclude that from occurring again going forward.

Chairman SHELBY. Chairman Shea, the National Strategy for Critical Infrastructures and Key Assets adopted following the 9/11 attacks emphasized that the fundamental need for food as well as great public sensitivity to food safety makes assuring the security of food production and processing a high priority. In your opinion, can the concerns regarding U.S. food security be adequately addressed by the current review processes, including those of the Committee on Foreign Investment in the United States?

Mr. SHEA. Well, I am reminded by what Senator Grassley says, we are nine meals away from a revolution here in the United States. If you do not get nine meals, people are going to be very unhappy. The Chinese obviously consider food——

Chairman SHELBY. Would it take nine meals?

Mr. SHEA. Nine meals, that is what Senator Grassley said, so I kind of stick with him. But, yes, I think food security should be an issue. I support efforts to include the Department of Agriculture as part of the CFIUS review of transactions affecting U.S. companies in the agricultural area. So I think that is a valid point. So I think food security is something we should pay attention to in the United States. I do not think any Chinese transaction currently threatens, or any other transaction from any other foreign company threatens, U.S. food security. But I think it definitely is a concern that should be taken into account in the CFIUS process, and the Department of Agriculture ought to have a seat at the table.

Chairman SHELBY. Thank you.

Senator Brown?

Senator BROWN. I am still pondering what nine meals and revolution. That is something with the Great Leap Forward or something.

Dr. Wilson, congratulations on your first testimony. Nice work so far.

Mr. WILSON. Thank you.

[Laughter.]

Senator BROWN. Mr. Gibson, I want to start with you. Witnesses have commented on the current state of the Chinese financial system. We make a mistake, I think we all know that, if we look at it as a system in the same sense of our own financial system or like that of other market economies since the most important element of the system, their system, is government.

Discuss, if you would, Mr. Gibson, how much Chinese banks lend to the steel industry. Is it increasing? Do you know how many of these loans are at risk of default? Would China let their state-owned enterprises default on these loans? Talk that through so we understand better.

Mr. GIBSON. You know, as far as the risk, it is a little bit hard for me to evaluate. The borrower and the lender are the same entity eventually at the top. We have data that indicates among the largest Chinese steel companies, they have accumulated a debt ratio of about 71 percent and about a half trillion dollars of debt.

We know from public sources that the reported losses last year for the Chinese steel industry were $15.5 billion. The financing is one of the advantages that the Chinese state-owned steel industry has, and it enables it to keep the zombie enterprises that have already been talked about in business. It allows these entities to keep operating, keep producing steel, and keep pumping that into the market. So the financing aspect of it, the public ownership of financing, the policies of the People's Bank of China with respect to the steel industry, which anyone can pull off the Web and read, which are to encourage, support, and promote the steel industry, including promoting the steel industry's directive from other parts of the Chinese government to seek capacity abroad to replace closed capacity in China, all those are part of the problem that are feeding this overcapacity issue.

As far as the risk of the loans, I think I would let others talk about the risk of these loans. They would be highly risky loans in a market economy, but, again, since the lender and the borrower ultimately are the same person, pretty hard to quantify risk, what their risk tolerance is.

Senator BROWN. Let me take that further. You have obviously talked about overcapacity. What steps does China need to do to live up to its previous commitment to reduce overcapacity in the industry? And how do we get China to take these steps?

Mr. GIBSON. I think China needs to see resolve. In order to get China to act, China would probably rather not discuss overcapacity at a Strategic and Economic Dialogue or at a G–20 Summit. They are being forced to. Why are they being forced to? Well, in the United States our industry is using the trade remedies available to it under the trade laws to bring trade cases. China in most cases is choosing not to defend those. So we are acting domestically using

the laws, and the improvement in the laws has enhanced our ability to make the cases in a timely way and to be able to get good margins in cases where the Chinese do not even supply data.

So we have to use our laws. We have to engage in diplomacy, and I think you saw that coming out of the G–7 Summit where the issue of overcapacity in steel and other industries was one of the leading topics discussed. It was also one of the leading topics discussed at the S&ED. The Chinese were forced to confront that.

Now, the Chinese have plans, and they have had plans before. I have got a list here I could supply for the record of the various Chinese steel capacity reduction plans. They have been aware of this problem since the middle of the last decade. They have repeatedly issued plans to address overcapacity. And at each step, capacity has increased. They claim credit sometimes for a capacity reduction due to one of their last plans, 90 million tons. The State Council claimed credit for that between 2011 and 2015. In fact, their capacity increased by over 300 million tons. They do not use the word "net." They may have closed 90 million tons of obsolete capacity somewhere. Their net capacity has increased.

So we just have to continue to use the trade remedies that are available to us. As we are using them, that steel is finding homes elsewhere because their exports to the globe, to the rest of the world, are actually increasing, up 20 percent last year, and now seemingly going to be up again this year. So others need to look to their own trade remedies, and we need to continue using trade diplomacy and forcing China to confront it and follow through on these commitments.

Senator BROWN. OK. I would like to hear from the others on that same question. What do we do? What do we do to get China to take the needed steps to reform the economy? Obviously, policymakers—from ITC, the Department of Commerce, to us on this panel—need to show resolve with China. But, Mr. Shea, if you would, and then Dr. Lachman and then Dr. Wilson, your thoughts on that.

Mr. SHEA. I think the conundrum is that there are people in the Chinese leadership who understand what needs to get done to get their economy on a more sustainable path, reducing overcapacity, moving away from an export-led, infrastructure-led economy, to one more focused on domestic consumption.

The problem is making those changes can be very painful to the Chinese people. If you are laying people off in steel, hundreds of thousands of people potentially in these steel mills and other industries with overcapacity, other steps that need to be taken could be very painful.

So what the Chinese—the key thing for the Chinese is the primacy of the Communist Chinese Party and the preservation of their power. So the leaders say, many of them, OK, we need to go this way, but the pain is so great, in the short term it could be destabilizing to them. And so I have to say I am pessimistic that the Chinese government, based on the desire to preserve domestic stability, in the short term at least, will force them to make the necessary changes.

Senator BROWN. Dr. Lachman?

Mr. LACHMAN. I very much share Mr. Shea's view that this is not at all an easy process for the Chinese. The point is that the

Chinese have allowed their economy to become hugely imbalanced; that if you look at the Chinese—just to quote one statistic, China has been investing something like 45 percent of its product, and its whole model has been this investment-led, export-led kind of model. To shift away from that, to bring that down to something like 30 percent is a huge undertaking, and it seems that the knee-jerk reaction—they said that they were going to do it at the end of last year, but the first quarter, what we saw is we again saw a massive increase in credit to keep the enterprises alive and not to do anything about the excess capacity problem.

So I know am afraid I share the pessimism that you are not really going to get much out of the Chinese.

Senator BROWN. Thank you.

Dr. Wilson?

Mr. WILSON. Yes, I have to say the level of excess capacity in many basic industries is a serious problem right now in China—steel, cement, oil refinery, even solar panels. The Chinese Communist Party is essentially between a rock and a hard place. I remember when I bought my first apartment, I actually painted myself into a corner. I guess I am not that bright. I think the CCP has done essentially the same thing. They have essentially two options. They have two options. The biggest engine of growth in the Chinese economy has been fixed-asset investment. It has been running 45 to 50 percent of gross domestic product. No other country in the world is experiencing these levels. Even South Korea, Hong Kong, Taiwan during their great growth periods in the 1960s and 1970s never had fixed-asset investment at 50 percent of gross domestic product.

I am also a mathematician, too, so if you look at the math, to bring that down to a more sustainable level—in other words, to reduce the excess capacity to, let us say, 30 percent of gross domestic product—ensures basically a financial crisis, a strong macroeconomic contraction. And so the Chinese authorities have two choices. They can continue—by the way, one more thing. Credit growth in China in the first quarter grew at its fastest pace since the 2009 stimulus package. So they are still growing the credit. So if they can cut back, have the recession now, or wait a few years, and it can be a lot worse. Those are essentially the two choices.

Senator BROWN. Let me ask in closing one just yes-or-no question, starting with you, Mr. Gibson. Should China be granted market economy status?

Mr. GIBSON. No.

Senator BROWN. OK. Mr. Shea?

Mr. SHEA. No. If you look at the statutory obligations for market economy status, Chinese does not—there are six points. China does not meet most of those points.

Senator BROWN. Dr. Lachman?

Mr. LACHMAN. No.

Senator BROWN. Dr. Wilson?

Mr. WILSON. No. Especially since 2002, it has been a state-led capitalistic economy. I would not grant its economy that status.

Senator BROWN. OK. Thank you.

Chairman SHELBY. Senator Heitkamp.

Senator HEITKAMP. Thank you, Mr. Chairman, and thanks to the Ranking Member for holding this hearing. And I want to thank the panel of experts. I think this is a critical issue, not because we worry so much about the Chinese economy, but we worry about the effect of the Chinese economy on the economy of the world and certainly the economy of the United States.

And so over the past 12 months, I have watched market volatility rise and fall and being affected by speculation, one would argue, but certainly by concerns about what is happening in the Chinese economy.

I asked Assistant Secretary for International Finance Toloui to come into my office and talk about the Chinese banking system, and from Treasury's perspective, what are the risks, where do we think we are right now, and what are we looking at. He did a great job, I think, kind of running through the paces on where we are right now, what the concerns are, and honestly saying, you know, this is a situation that needs to be watched but do not press the panic button yet.

So I want to ask a couple questions about where we are right now in terms of our evaluation of the Chinese economy, of the potential credit bubble, and what that means for the American economy, and then also, you know, what we cannot see. We see the institutional kind of structure that we are allowed to look at, but we have got the whole concern about what is happening with shadow banking and what is happening with what we cannot see.

And so I guess my first question would be for anyone on the panel. You know, the Chinese government has made commitments to be more transparent and to improve kind of their financial data and financial reporting. How many of you believe that China will actually follow through on those commitments, that we will actually get better data as a result of that commitment? And then, second—because I think I know your answer already—what are the secondary tools that we can, in fact, utilize that will give us better data and better insight on what is actually happening institutionally with Chinese lending? I would just start here with Mr. Shea and work down the row.

Mr. SHEA. Well, you have heard about the credit bubble, close to 300 percent of GDP. Shadow banking is a concern. Transparency, greater transparency, that is something that the Chinese Communist Party is not really too keen on, so I would not be optimistic on seeing a tremendous amount of greater transparency.

Let me just make a point that has been raised, if it is all right. It relates to your question. This China-America thesis that the Chinese and the American economies are so interrelated that they are one and the same thing, that is not true. China is not America's banker. Please do not say that. This——

Senator HEITKAMP. I do not think I did.

Mr. SHEA. I know, but I have heard——

Senator HEITKAMP. In fact, I think if you had Treasury here, you would hear exactly that, that this has been overexaggerated in terms of the risk to the American economy. But it still needs to be watched.

Mr. SHEA. Right.

Senator HEITKAMP. My question is—you know, I think we all agree that we are not going to get transparency. The question is: Short of actually getting data that we can rely on from the Chinese government, where do we go to actually have a deeper and better understanding of what is happening with credit in China?

Mr. LACHMAN. That China's not transparent certainly is very clear, that it is not just a question of the banking statistics, as has been mentioned before in terms of their whole GDP numbers. All of this seems to be rather fictional. You know, I very much agree that China is not growing at 6.7 percent. It is, rather, growing at something like 4 percent. I would think that these problems are very deep-seated, that they are serving a Communist Party that is wanting to stay in power that does not really have an interest in transparency. And the problem might be that they have got control over the banking system in a way other countries really do not.

Senator HEITKAMP. I think we all understand—I do not know if I am just being too opaque here, like the Chinese, but what I am trying to get at is we do not believe and I do not believe that we will get reliable data from the government, and the government right now is a source of information. What are the other sources of information that we can utilize to better evaluate? You know, you are speculating on what the actual gross domestic product is of China. Why should we rely on your 4? Why shouldn't we believe it is potentially 2 or 1.5?

Mr. LACHMAN. Right, well, if one has to do this privately and one has to do this indirectly, you are going to have a range of estimates. So basically what people are doing is they are trying to figure this out from various indicators. Instead of looking at GDP as it should properly be put together, what they are doing is they are looking at electricity consumption, credit expansion, tourist traffic, rail freight, and so on, and trying to pull it up from the ground. But you are really only going to get indications that the official numbers are very——

Senator HEITKAMP. Doctor, do you think that is complicated by shadow banking, by—you know, we do not really know what the complete credit picture is because we do not know—historically, I would imagine there has been a lot of shadow banking. That has been traditional methods of funding capital or moving capital that could be below the rate or even for the government. And so the question is: How much risk do you think we have in shadow banking?

Mr. LACHMAN. Certainly, in China there is considerable risk. We know that the shadow banks have been very active in extending credit, and this would be a problem in a country that was not run by the Communist Party, you know, to have shadow banks——

Senator HEITKAMP. Well, we have shadow banking.

Mr. LACHMAN. Correct. If that is not properly regulated, you can really run into difficulties on that score. That is a source of concern. But as I——

Senator HEITKAMP. Do you agree with Mr. Shea that we have overexaggerated probably in the media more than any place the interconnectivity between the American economy and the risks to the American economy from Chinese bubbles?

Mr. LACHMAN. Well, the risks might be there, but what I would just note is that last year what occurred is because of capital flight out of China, China reduced its Treasury holdings by a fair amount. It reduced its international reserves from something like $4 trillion to $3 trillion. There was a decline of $1 trillion in their international reserve holdings, and the world did not come to an end. You know, so the notion that they can really disrupt our markets, you know, would seem to have been tested last year.

Senator HEITKAMP. I am out of time, and so I will probably submit some questions for the record. But I just wanted to make sure that we got the point.

Mr. SHEA. Brookings Institution has done some work on Chinese shadow banking, and the work I have read indicates that they do not think it is that big a concern in China. So we can get that for you.

Chairman SHELBY. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

There are many disadvantages to American businesses with respect to China's market barriers, its impediments to competition, lack of transparency, state monopolies, government subsidies, currency manipulation, discriminatory industrial policies, restrictions on trade and distribution rights, the lack of intellectual property protections. So as of March of this year, the United States has bought 17 WTO dispute settlement cases against China on cases in each of these issue areas. Clearly, we have identified many areas of disagreement with China.

My question is: Is there any evidence that WTO actions or any other actions have actually changed China's policies or behaviors? And if the answer to that is no, then what, in fact, should we be doing beyond our WTO objections? Does anyone have an opinion on that? Mr. Shea?

Mr. SHEA. Well, the WTO process is costly, not necessarily accessible to small- and medium-sized businesses in the United States. It takes a long time. And even after favorable decisions by the WTO in the interest of the United States, sometimes the Chinese do not abide by what the decision was. And I am thinking of the distribution of movie rights, movies into China, as one specific example.

So I think the system is effective to some degree, but it is certainly not a satisfactory system for responding to all the things that you just listed as problems in our trade relationship.

Unfortunately, this is something we struggle with on the Commission, is to how to come up with sort of effective responses. One thing, I think the USTR, for example, should initiate cases. Sometimes companies are afraid to come forward, and the USTR should initiate cases if they feel the national interest is being jeopardized. I think companies are subject to forced technology transfers, and I think we ought to look at the antitrust laws to allow U.S. companies, as long as their—in addition to other Western companies—to talk to each other about, you know, we are not about resisting these forced technology transfer and other requirements without having to worry about whether they are violating the U.S. antitrust laws.

So my testimony lists a few other things. I think multilateral action is always much more effective than the United States going alone, so working with our allies. One idea I heard recently was to create a Department of Trade Enforcement within the Justice Department. The USTR negotiates trade deals, but maybe put a trade enforcement function within the Department of Justice. That is an idea that I have heard raised.

Senator MENENDEZ. Mr. Gibson?

Mr. GIBSON. Thank you, Senator. I would say that was one of the reasons it was so important to get the trade law improvements last year, because those are tools that are in our control to use to bring the cases. The changes help.

Another thing that helps is increased resources for trade enforcement, and the Appropriations Committee made additional resources available last year to enforce these new laws that were passed last year and is even thinking about putting a little bit more money toward that this year.

So that is our other option, is to use the trade laws and to bring cases and to enforce the trade laws where we find violations.

Senator MENENDEZ. On the Finance Committee, I raised this issue about it seems to me that the burden is disproportionately put on private companies to be the prosecutor of violations of international agreements, when it should be the Government. Companies could provide information to the Government in order to make that analysis and then have the Government be the one to prosecute the violations and not have the burden on the private sector and/or steelworkers or others to try to prove what is going on. So I look forward to continuing to pursue that line of opportunity because to the extent that there are going to be trade agreements, one of the undermining elements of it is that there is a lack of enforcement. So what good is an agreement but for the ability to enforce it and the rule of law to be able to ultimately pursue your differences.

Let me ask this question: There are some who suggest that our two economies—the United States' and China's—are so intertwined that failure for one means failure for another, and I think some of you have touched upon these remarks. I often hear from people running for office that China has a powerful tool against us, which is their $1.2 trillion large-scale investment in U.S. financial assets, and that a disinvestment of China in that regard would be catastrophic.

Under what scenario would it be possible that China would decide to suddenly and significantly reduce their liquid U.S. financial assets? And if they were to do that, isn't there a very significant consequence to them as well? Dr. Lachman?

Mr. LACHMAN. Well, as I mentioned, we saw something like that last year. You saw a circumstance in which China reduced its international reserves by around $1 trillion because they had a huge amount of capital outflow, yet it did not seem to have much impact either on United States interest rates or on the United States dollar. So I am not sure that I see this as a very effective weapon, and there is also the point that using that kind of weapon might not be in your own interest, you know, to be dumping Treasury bills at a loss. So I am not sure that I see this as something

that we really need to be too worried about. What we do need to be worried about more is the continuation of the imbalances in China and what that might imply for the global economy. You know, if those imbalances get even more out of line, the disruption could be very large to the United States economy.

Senator MENENDEZ. One final question, Mr. Gibson. If China through its illegal dumping subsidies and continued growth of capacity is allowed to decimate the U.S. steel industry further, what is your prediction for the shape of the U.S. industry? And how long does the industry have before the United States could be dependent on other countries for its infrastructure and defense needs?

Mr. GIBSON. Well, you know, the situation right now is quite dire. The damage done to the industry has been extreme over the past few years. We have seen this once before recently in the decade beginning in the end of the 1990s, late 1990s into the 2000s. We saw a restructuring of the U.S. steel industry, 33 bankruptcies. We went from 46 steel-producing companies to 29 steel-producing companies. You only have to look out your right window driving up I–95 when you go through the Harbor Tunnel and look at what used to be the largest steel plant in the world at Sparrows Point, which is no longer there. It is gone.

So over the long term, we need to get a remedy to this, and the industry is availing itself of the remedies as under U.S. law. And that can deal with imports from China into the United States.

Unfortunately, China has not reduced its capacity. It is continuing to produce at a high level, even as its own demand decreases, which means it is pushing out more into the world market, which is displacing steel in other countries, making them look to a market such as the United States. So we need to be on this right now. It is an immediate problem.

Senator MENENDEZ. Thank you.

Chairman SHELBY. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman, and thank you all for being here today.

The data show that China's economy is caught between a rock and a hard place right now. Since the 2008 crisis, it has relied on massive amounts of debt to finance its ambitious growth targets, but now the debt has lurched out of control. A decade ago, China's debt relative to its GDP was about 150 percent. Today that ratio is 260 percent. And the payments are coming due on this.

I understand that now 40 percent of all new debt goes to making interest payments on old debt. So it is more and more debt before they even get any growth in this.

The number of delinquent loans has doubled in just the past 2 years, and these are all classic signs of a credit bubble about to burst.

So China appears to have two options: it can cut back on credit and let current economic growth sag; or it can keep pumping more debt into the economy, propping up the growth now but setting the stage for a bigger crash down the line. The impact on the global economy and the U.S. economy will depend in part on which of these two paths that China takes.

So, Mr. Shea, can I start with you? Which path do you think China is going to take on this?

Mr. SHEA. I think they are going to take the path of least resistance. I think they are going to take the path that in the short term they perceive as being in the interest of the Chinese Communist Party staying in power, which means making sure that people are relatively happy and not losing their jobs, not suffering.

So I think, again, they know what needs to be done. They are doing some steps on the debt. They are securitizing some of the debt. They are creating, you know, companies to offload some of the nonperforming loans, which they did this 10 years ago. They created asset management companies that were basically zombie companies that took all this debt. They are experts at pushing the problem down the road further and further. They are really good at that.

But, again, the point is that they know what needs—many of them know what needs to be done, but the pain in the short term is so hard that they are concerned that it is going to jeopardize the stability of the country and the primacy of the Chinese Communist Party. So that is——

Senator WARREN. So you think they will just continue to——

Mr. SHEA. I think they will muddle along. I think they are going to muddle along.

Senator WARREN. All right. Well, let me ask about this, because I want to dig in just a little bit on this. We have already talked about a little bit that the experts cite data to show there would be fairly modest direct harms to the U.S. economy from a slowdown in the Chinese economy. And you have already talked about it here this morning. And most of the people who talk about this note that U.S. investors have very little money directly in the Chinese stock markets. According to some expert analysis, U.S. exports to China make up only about seven-tenths of a percent of our GDP. So the general impact, it seems there is some consensus around the notion that the general impact to our economy if China starts—whether it is in the very short term or down the line starts down, it is not going to be as severe for us.

But I want to dig in a bit more on the exposure of our financial sector to the Chinese economy and specifically to its banking system. After all, it is China's banking sector that is the world's largest, yes, larger than the United States, with total assets equal to about 40 percent of the entire global economy. And while investors here at home may not have significant direct investments in Chinese companies, there are other ways that we are exposed. You talked recently about the impact of disinvestment and said it has not had the big impact we expected. But big banks and financial institutions in the United States are certainly exposed through derivative trading and other financial interactions to sharp changes in commodity prices and currency valuations that would result from any turmoil in the Chinese market.

So, Mr. Shea, if the Chinese credit bubble pops, whether it is sooner or later, dragging the Chinese economy down with it, what kinds of vulnerabilities might we see in our U.S. financial services industry?

Mr. SHEA. Well, I was going to kick that over to Dr. Lachman——

Senator WARREN. Well, I am going to Dr. Lachman next, so it is entirely up to you.

Mr. SHEA. Yes, I think it is the financial sector that is probably the most exposed to the Chinese economy. You correctly point out they do not own as much Treasury debt as we say—as commonly believed. There are—not a significant portion, I think 7 percent of U.S. exports are to China. The FDI between the two countries is quite minimal as a percentage of global FDI, of U.S. FDI to China, Chinese FDI to the United States. So we are not as intertwined as commonly believed. As has been pointed out before, there are second-order effects. Other economies in the world are very intertwined, particularly commodity-exporting economies like Australia and Brazil are very intertwined with the Chinese economy, much more so than ours, and as a result, our relationship—if those economies go down, then we get affected as well. But that is a second-order effect.

I am going to turn it over to Dr. Lachman.

Senator WARREN. Dr. Lachman? I was coming to you anyway to ask about this question about what happens with the largest financial institutions in the United States and their exposure on derivatives and other financial transactions.

Mr. LACHMAN. Well, the way I think about it is, firstly, I would say that it is very unlikely that you are going to get the bubble bursting in the way that occurred in the United States because they have got control over the banks, they have got control over the state enterprises. They are going to be just pumping in credit to keep zombies alive, you know, much like what Japan did.

So, for instance, if you look at what happened in China at the first quarter of this year, while the government realizes that they do have to transform their economy, that did not stop them from increasing credit by something like 40 percent, the fastest rate that they have done, you know, repeating those practices. So it seems unlikely to me that you are going to get the bubble bursting.

Where you could get an impact on the United States financial system and on the United States economy is through the impact that China would have on the global economy, that China is the second largest economy right now, has been providing most of the growth, and at a time that we have got real trouble in many other economies around the globe. I am thinking of a place like the U.K. now, Italy, Brazil, Japan, and emerging markets. A Chinese slowing is the last thing that you are really wanting to do.

So I do not think that one should be complacent about the impact that this might have on the United States banking system, but I do not see the impact as being through direct exposure of United States companies.

Senator WARREN. So you are not worried about the exposure through derivatives that, for example, put our banks deeply engaged on the question of commodity prices or other financial transactions more directly?

Mr. LACHMAN. Oh, absolutely, I would be concerned about that. But it is not to China itself. It is, rather, through China's impact on world commodity prices, China's impact on the outlook for other countries that are struggling to get their economies going. Then, you know, the United States banking system is hugely exposed, for

instance, to Europe. So, you know, if Europe going through its problem with Brexit or having trouble likely to occur with the Italians, their referendum, the last thing you want to do is to have yet another part of the global economy not doing well, and Chinese is a major part of the global economy.

Senator WARREN. Thank you. That is very helpful. You know, I hear you saying that a sharp slowdown in the Chinese economy would have these massive ripple effects around the global economy. And I understand you to be saying that in the United States the big financial companies would be the place where we would be most exposed. That is exactly in anticipation of these kinds of risks that Dodd-Frank requires big banks to build in more safety ahead of time, with capital requirements and leverage ratios. And that is why it is critical that financial regulators have the tools they need to shore up the safety of the U.S. banking sector.

Every time Congress tries to weaken Dodd-Frank regulations, it puts our country at risk.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you, Senator Warren.

Just a few observations from the hearing but from our experience, too. We know that China—or at least my observation—I have been there. I have not lived there, but I have been there since 1981 a number of times, and I have seen a lot of changes. But China signs these agreements, these trade agreements, and then they make their own rules or ignore what we are doing. They are obviously "eating our lunch" in trade. Look at the current account, you know, what we are doing there. There has got to be a day of reckoning there.

We all know we have to trade. My gosh, we have got to trade. We cannot build walls around this. But is the problem with China that China is going to sign an agreement and do what they want to? Because the imbalance of trade with China, not just steel—but steel is important, you know, to us for defense and everything that goes with this. But they seem to target an industry, a big industry, and people disappear. You know, companies disappear, jobs disappear. And this has now manifested itself into the current Presidential race—do not kid yourselves—in the current races around here. Are we trading? Are we smart? Are we stupid or whatever? Dr. Wilson?

Mr. WILSON. Yeah, I would say this: During the 4 years I was there, the most significant change I witnessed in China is the fact that if you talk to the U.S. Chamber of Commerce, the European Chamber of Commerce, they will tell you this unambiguously: that doing business in China has become much more difficult in terms of regulation, in terms of entry, getting into the market.

Obviously, you know I am with the Heritage Foundation, so I am a free trade guy. But, still, we ran a trade deficit—it is mind-boggling. We ran a trade deficit last year with China of $365 billion. That accounts for about 80 percent of our annual trade deficit.

Chairman SHELBY. Isn't that unsustainable economically speaking? I mean, it will go on for a while.

Mr. WILSON. It can go on for a while. The great thing about the U.S. economy is this: that it is very insular. If you look at exports and imports as a share of GDP, it is only about 25 percent. Other

countries like South Korea, Taiwan, it is 70, 80 percent. And so the fact is this: The global economy is growing at one-half the rate it was a decade ago. These have been tough times. Brazil, Lula said in 2009, when they were booming and we were in trouble, that the financial crisis was caused by blond-haired, blue-eyed bankers. As a former banker, I took some resentment for that, and I said that, you know, given their connectivity with the Chinese economy, this is a major reason why China, Indonesia, South Africa, Russia—I mean, oil prices as recently as 2014 were above $100 a barrel. Now we are at $40. Who would have expected oil to be a $40 a barrel? This is largely the result of the slowdown. We are already experiencing this. The Chinese economy has already slowed down. As recently as 4 years ago, it was growing at 10, 10.5 percent, now maybe 5 percent. That is an enormous deceleration for an economy producing one-third of global economic growth since 2008.

But, yeah, I will just finish by saying that it is very disappointing. I talk to businessmen in Beijing, and doing business there for the corporate blue chips has become increasingly difficult.

Chairman SHELBY. But we should have no illusions that China is trading with the United Kingdom or with Germany or anybody else?

Mr. WILSON. Correct.

Chairman SHELBY. It is a different world, is it not?

Mr. WILSON. It is.

Mr. SHEA. Could I—Mr. Chairman, you are exactly right, Mr. Chairman, your comments, and you asked the question, "Are we stupid?" Let me add another layer to your question. We are the China Economic and Security Review Commission. The United States has brought China into the world, has helped build up its economy by providing a market, by investing, and by transferring, whether we like it or not, technology to China.

Chairman SHELBY. Big time.

Mr. SHEA. While we are doing it, the Chinese are using the money to buildup their military, 10 percent a year over the past 15 years, and they are——

Chairman SHELBY. Oh, yes, and will continue.

Mr. SHEA. Yeah, and their military strategy is designed in part directed at the United States, to keep us out of the Western Pacific. So they are building weapons systems that would attack U.S. military assets.

So are we stupid?

Chairman SHELBY. That is the question.

[Laughter.]

Senator BROWN. This is kind of amusing. I was in the House when permanent normal trade relations (PNTR) passed, and I helped to lead the opposition to it, and I heard—normally, CEOs of big companies come to Congress and go to leadership offices in the House and the Senate. They actually come see people like Senator Shelby and me, but in the House they go to the leadership. But the CEOs of the biggest companies were even going to the fifth floor of Cannon to lobby on PNTR. And they would always talk about they could not wait to get access to 1 billion Chinese consumers. Well, they really were looking to get access to 1 billion Chinese workers. And when I hear Dr. Wilson in his first

testimony—again, nice work, but when you said how these corporate blue chip companies, it is so hard for them in China, I mean, it was not my idea that they go to China. It was not my idea that Apple does all the innovation in this country and then goes and outsources its jobs. It was not my idea that these companies begin almost a new phase in economic history where they shut down production in Cleveland and Toledo and go to Wuhan and Shihan, get a tax break to do it, and then sell the products back in the United States. That was not invented—that was what the U.S. Chamber of Commerce and major companies did. And when I hear them say, "Oh, it is so hard to do business in China," then come back. But the dollars that you are—I mean, I do not really know who funds the Heritage Foundation. I suppose it is the Koch Brothers that fund most of everything else in this town. But I do know that you talk about the Chamber of Commerce and how their members have made so much money at the expense of my once-middle-class workers in Mansfield, Ohio, where I grew up, and Akron and Youngstown and Steubenville and Worcester, Mass., and then I hear complaints about how hard it is for these businesses to outsource jobs from China, and you talk about the Presidential election, this suit I wear, made by union workers 6 miles from my house in Cleveland, Ohio. Yet we have Presidential candidates that complain about trade policy and then they outsource jobs because they cannot find a company in the United States to make their furniture. Go to Archbold, Ohio. They can find a company that makes furniture. They can find suits here.

So I just—when I see the business model of this country in the last 25 years, in many ways accelerated by PNTR, bad decisions in this body, and they move overseas after shutting production here, sell those products because the labor is cheap, the environmental rules are weak, the currency is in their favor, and now they complain about it, I guess I would just say, "Come home, then." Enough said.

Mr. GIBSON. You know, China joined the WTO. The WTO did not join China. Right? We have got to hold them to the rules. We have got to use our trade laws when they violate the rules and be able to have remedies against them.

Chairman SHELBY. Well, I thank all of you. I think this has been an interesting hearing. We have to face reality.

The hearing is adjourned.

[Whereupon, at 11:25 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

Testimony of the Honorable Dennis C. Shea

Chairman, U.S.-China Economic and Security Review Commission

before the U.S. Senate Committee on Banking, Housing, and Urban Affairs

Hearing on "Evaluating the Financial Risks of China"

July 14, 2016

Thank you, Mr. Chairman, Ranking Member Brown, and Members of the Committee, for the opportunity to testify today. Before we begin, I would like to note that this testimony reflects my personal views and not necessarily the judgments of the U.S.-China Economic and Security Review Commission. That said, my views are informed by my nine years of service as a Commissioner, and I commend to you the Commission's analysis of the U.S.-China relationship and the challenges and opportunities it presents.

When China acceded to the WTO in 2001, there was great optimism surrounding the future of U.S.-China relations. Supporters of China's entry into the WTO claimed that not only would the U.S. economy benefit from increased exports to China, but China's accession would also enhance U.S. national security, lead to greater liberalization of China's authoritarian political system led by the Chinese Communist Party (CCP), and transform China's state-dominated economy into one driven largely by market forces.

Unfortunately, these high expectations have not been realized. The government continues to dominate many aspects of China's society and economy, and many important businesses remain state-owned or state-controlled. At face value, the recent reform initiatives, including those highlighted in the Third Plenum and the 13th Five-Year Plan, promote restructuring and efficiency, but their ultimate aim is strengthening government's role in the economy with the purpose of preserving the primacy of the CCP. This presents a particular challenge for the United States, whose companies are directly affected by China's actions.

The rest of my testimony will be spent discussing some of these issues in greater detail.

STATE CONTROL OF THE ECONOMY

The Chinese government props up its state-owned enterprises (SOEs) and designated private firms while limiting market access for U.S. and other foreign firms through strict market entry criteria, opaque regulations, compulsory joint ventures, and China-specific technical regulations. These policies create an uneven playing field that disadvantages U.S. companies both in China and abroad.

- **SOEs remain an essential driver of China's economic growth.** While market-oriented reforms in China have led to a rapid expansion of the private sector, SOEs remain the driving force behind key sectors of China's economy, with most of the largest companies in China owned or controlled by the central government.* [1] For instance, in 2013 China's 500 largest firms—both private and public—earned $9.2 trillion, half of which was earned by central SOEs.[2] In 2014, all SOEs accounted for 17 percent of urban employment, 22 percent of industrial income, and 38 percent of China's industrial assets.[3] According to a June 2016 speech by David Lipton, the International Monetary Fund's first deputy managing director, SOEs account for more than one-fifth of China's total economic output.[4] SOEs also maintain a controlling position in China's stock markets—the ten top-valued companies in China's Shanghai Composite Index are all state-owned.[5] State monopolies administered by the central

* The *Fortune* Global 500, a list of the world's largest companies by revenue, featured 98 Chinese companies in 2015. The 12 largest Chinese firms were all state-owned, while only 22 of the Chinese companies listed were privately owned. Scott Cendrowski, "China's Global 500 Companies Are Bigger than Ever—and Mostly State-Owned," *Fortune*, July 22, 2015. *http://fortune.com/2015/07/22/china-global-500-government-owned/*.

government are particularly important drivers of the economy, with SOE contributions in monopolized sectors like oil and gas, electricity, and tobacco reaching more than 90 percent of China's industrial output, compared to between 25 and 30 percent for the average state firm across all sectors.[6]

- **Under President Xi Jinping, the government is redoubling efforts to increase its control over private and public companies in key industries.** Despite repeated pledges to let the market play a "decisive role" in resource allocation, Beijing continues to use SOEs as a tool to pursue social, industrial, and foreign policy objectives, offering direct and indirect subsidies and other incentives to influence business decisions and achieve state goals.[*] [7] These efforts are evident in China's economic reform plans, which seek to help SOEs become "bigger and stronger," not reduce the size of the state sector.[8] An important component of reform is to transform SOEs through "mixed ownership"—in other words allowing private investors to take stakes. Other forms of private capital in SOEs are also welcome, including foreign capital, with SOE managers encouraged to pursue overseas mergers and acquisitions, joint investment and financing, and offshore financing.[9] However, under these reforms, the state will maintain the "absolute controlling position" even as direct state ownership declines.[10] The central government already reserves the right to appoint all senior managers in central and local SOEs, while chairmen and chief executives of these companies are often concurrently the heads of their companies' party committees, allowing the government—not market forces—to influence where resources are allocated.[11] An article written by the State-owned Assets Supervision and Administration Commission (SASAC) in June 2016 further highlights the power of party cells within every SOE, stating, "All the major decisions of [SOEs] must be studied and suggested by the party committees," with "arrangements involving macro-control, national strategy and national security … studied and discussed by the party committees before any decision by the board of directors or company management."[12]

- **The government's influence over private companies is often underestimated.** In testimony before the Commission in February 2016, Wentong Zheng, associate professor at the University of Florida's Levin School of Law, stated that "the hallmark of Chinese state capitalism is an ecosystem in which the government is at the center of the economy and everybody else caters to the government's needs."[13] In this ecosystem, public and private managers alike are incentivized to foster close ties with the government.[14] There are a myriad of ways the state exercises influence over private companies, including through indirect ownership of the private company via a controlling interest in a "legal person" entity,[†] an agreement among shareholders, or financial incentives.[15] Huawei, for instance, is a privately held firm but receives major funding from state banks.[16] Privately owned automobile manufacturer BYD Co. also benefits from state support, receiving $108 million in 2013 from local and central government subsidies, more than 120 percent of its net profits for the year.[17]

- **Beijing seeks to maintain control of strategic sectors that advance the state's political and economic interests.** Economically strategic sectors (such as industrial producers) enable the government to support short-term economic growth, while politically sensitive sectors (such as telecommunications) are essential to the government's goals of advancing and controlling China's technology infrastructure, disseminating information, and protecting national security (for a list of strategic sectors identified by the Chinese government, see Appendix, "China's Strategic Sectors

[*] China's state goals include enhancing indigenous innovation, reducing overcapacity, and developing the country's high-technology and environmental industries, including biotechnology, high-end manufacturing equipment, and new-generation information technology (IT), among others. See U.S.-China Economic and Security Review Commission, Chapter 1, Section 3, "China's State-Led Market Reform and Competitiveness Agenda," in *2015 Annual Report to Congress*, November 2015, 158–162.

[†] For more on "legal person" entities in China, see Marshall W. Meyer and Changqi Wu, "Making Ownership Matter: Prospects for China's Mixed Ownership Economy," *Paulson Institute*, September 2014. *http://www.paulsoninstitute.org/wp-content/uploads/2015/04/PPM_Making-Ownership-Matter_Meyer-and-Wu_English.pdf.*

Identified in State Plans"). The higher the degree and broader the scope of a sector's strategic value, the more likely the Chinese state will enhance its control, centralize bureaucratic coordination, and regulate market entry to achieve state goals.[18] Firms operating in strategic sectors—like military industry, electrical power generation and grids, petroleum and petrochemicals, telecommunications, coal, semiconductors, civil aviation, and shipping—are the primary beneficiaries of government support.[19] For instance, in the telecommunications sector, business activities are subject to heavy central-level control, and industry actors are commonly state-owned or state-controlled.[20] Sector-specific rules on pricing, market entry and exit, business scope, technical standards, and ownership structures maximize the advantages provided to state companies—namely, absorbing technology from foreign operators who are unable to compete within the state-promoting regulatory environment—while simultaneously enhancing state management of network infrastructure and technology.[21]

RELATIONSHIP BETWEEN STATE AND FOREIGN COMPANIES

Foreign companies have played an important role in building up and supporting the Chinese economy. According to official Chinese data, in 2015, exports and imports by foreign-invested enterprises in China accounted for 46.3 percent of the country's total trade.[22] Today, though the majority of U.S. firms still consider China a profitable market, optimism is waning.[23] While some of the difficulties—including rising labor costs and human resources constraints—cited by foreign investors in China are a normal consequence of China's economic transition, U.S. companies doing business in China face serious challenges in the form of inconsistent and unclear legal and regulatory enforcement, market access restrictions, and preferential policies that benefit Chinese companies. In fact, China's restrictions on foreign investment place it at the top of the Organization for Economic Co-Operation and Development's FDI Regulatory Restrictiveness Index.[24] As a result, while Chinese investment flows to the U.S. have grown rapidly in recent years, U.S. direct investment in China appears to have slowed and even decreased.[25]

- **China's legal and regulatory environment continues to create an uneven playing field for U.S. companies.** U.S. investors have little to no recourse to protect their rights or fairly resolve disputes under China's opaque legal system, which is designed to serve Chinese government interests.[26] Recent Chinese regulatory activities seem to disproportionately target foreign investors in strategically important industries, with China's Anti-Monopoly Law enforcement agencies—the Ministry of Commerce, the National Development and Reform Commission, and the State Administration of Industry and Commerce—failing to treat identical or similar violations of the law equally. As a result, regulations impose substantially varied penalties on companies in similar circumstances, with more leniency toward Chinese state-owned enterprises and more rigorous enforcement against foreign companies.[27] For example, in its reviews of proposed mergers and acquisitions between August 2008 and the first quarter of 2014, China's Ministry of Commerce exclusively blocked or modified transactions involving foreign companies, and imposed remedies that tend to protect and promote domestic industry and cap commodity prices and intellectual property (IP) royalties.[28] During this period, the Ministry of Commerce unconditionally approved 97.4 percent of the 1,006 total transactions it reviewed. All of the 26 transactions that were either rejected or conditionally approved involved foreign firms; 21 of the 26 cases involved foreign-to-foreign transactions.[29]

- **Market access restrictions continue to limit the ability of U.S. companies to invest in China**. China restricts foreign investment in many sectors where the United States maintains a competitive advantage, such as research and development (R&D)-intensive and value-added services sectors, in order to protect domestic companies and industries. Fluctuations in China's foreign investment restrictions follow a pattern where, at first, the government welcomes FDI into sectors deemed strategic for its national economic development in order to extract technology, IP, and know-how from foreign firms. However, after domestic industry is judged sufficiently developed, Beijing issues new policies restricting investment to push out foreign companies and free up the market for domestic firms. The automotive

industry is an example of this trend. China's industrial policies restrict foreign access to China's auto industry through requirements for technology transfers and joint ventures,* but encourages foreign automotive companies to invest in China and develop Chinese brands, particularly in the new energy vehicle market.[30]

- **China's government is introducing policies that aim to replace established market leaders with domestic firms**. The Chinese government's latest blueprint for its economy, the 13th Five-Year Plan, designates sectors such as semiconductors, biomedicines, cloud computing, mobile Internet, and e-commerce for additional government support.[31] These policies seek to break China's dependence on imports from foreign producers in sectors where the United States currently enjoys a technological advantage. For example, U.S. multinational firms dominate the global semiconductor industry, accounting for 11 of the top 20 global semiconductor suppliers and 51 percent of the $335.8 billion global market in 2014.[32] In response, the Chinese government has established a $19.5 billion 2014–2017 National Integrated Circuit Industry Investment Fund to provide high-level support and funding, establish national champions, and facilitate consolidation and global competitiveness of its national champions.[33] Local governments and private equity investment funds are expected to provide an additional $97.5 billion to the fund by 2020.[34]

- **Despite Beijing's repeated promises to open up its markets, U.S. companies believe the business climate in China is becoming less welcoming.** According to the American Chamber of Commerce in China's 2016 Business Climate Survey, 77 percent of U.S. companies reported they felt foreign businesses are less welcome in China than before, and 83 percent of technology, R&D, industrial, and resource companies reported China to be less welcoming.[35] This represents a dramatic increase over survey results in previous years. In 2015 and 2014, less than half of U.S. businesses stated that China was less welcoming.[36]

CHINA'S "GOING OUT" POLICY

Even as foreign companies face growing obstacles in China, the Chinese government is encouraging domestic companies to invest abroad through policy directives and subsidization. The approval process for outbound investment has been substantially liberalized: Most Chinese companies "going out" only need to make a filing for the record rather than apply for regulatory approval.† As a result, Chinese investment abroad—and particularly in the United States—has spiked. By mid-June 2016, Chinese companies had already invested $111.6 billion abroad, exceeding the $111.5 billion invested abroad in all of 2015.[37] Chinese investment in the United States is expected to set a new record in 2016, with as much as $30 billion in pending deals, up from $15 billion in 2015.[38]

- **Many Chinese companies investing abroad receive support from state banks and capital markets to advance state goals.** Companies in different sectors have different reasons for looking abroad: energy and resources firms aim to stabilize their domestic supply of resources and avoid price volatility, technology firms aim to acquire new technology, and manufacturing firms aim to acquire foreign brands and be closer to their target markets.[39] Ultimately, however, many Chinese companies are seeking government subsidies and other incentives—including low-interest bank loans and discounted

* Foreign automakers can only participate in China's auto market through forming joint ventures with local partners and transferring technology to Chinese partners. U.S. China Economic and Security Review Commission, Chapter 1, Section 2, "Foreign Investment Climate in China," in *2015 Annual Report to Congress*, November 2015, 84.

† Some restrictions remain. For example, outbound investments exceeding $1 billion still require approvals, as do projects of any amount in so-called "sensitive countries and regions" (including countries with which China has not established formal diplomatic relations, countries subject to international sanctions, and countries in state of war or internal unrest) or "sensitive industries" (including telecommunications, water management, large-scale land development, electrical power transmission, and news media). Marc Szepan, "China's New Overseas Investment Approval Rules: China's Big Deals Are Likely to Become an Even Bigger Deal," *MERICS*, April 15, 2014.

means of production—as a reward for furthering state goals.[40] Because these foreign acquisitions are aided by preferential government treatment and financial support from Chinese banks—thereby lowering SOEs' cost of capital and subsidizing production costs—Beijing's policies give Chinese companies a competitive advantage over U.S. and other private firms.[41] These foreign investments also increase SOE debt in China, with companies relying on risky loans from state banks to finance the deals.[42]

- **Chinese foreign investment is focused in strategic sectors.** The degree and scope of a sector's perceived strategic value establishes a framework for China's global integration, emphasizing the most valuable foreign investment opportunities for Chinese leadership.[43] Most of China's largest bids for foreign investment to date have been in strategic sectors like biotechnology (e.g., the $43 billion deal for the Swiss biotech and agriculture firm Syngenta), electronics (including a failed $3.3 billion deal for a majority interest in Philips' combined LED components and lighting business), and agriculture (most notably the 2013 acquisition of Smithfield Foods for $4.7 billion). Through May 2016, Chinese mergers and acquisitions (M&As) have largely taken place in strategic sectors, with nearly $50 billion invested in agribusiness and over $10 billion in technology, more than half of China's total M&As in 2016.[44] China has also actively pursued investments in the semiconductor industry, but the largest bids (including a $23 million offer for chipmaker Micron and a $2.5 billion bid for Silicon Valley-based Fairchild Semiconductor International) have been rejected or withdrawn over fears they would be blocked by U.S. regulators.[45] Focusing its foreign investment in strategic sectors enables Beijing to move up the value chain in high-tech sectors without having to develop domestic innovations.[46]

CONCLUSIONS AND RECOMMENDATIONS

China has benefitted tremendously from past economic liberalization and its close trading relationship with the United States. These are not abstract concepts: Witness China's massive trade surpluses, rising outward FDI, and burgeoning soft power. Several decades of economic prosperity have also fueled China's rapid military modernization and growing strategic assertiveness, most evident in the territorial disputes in the South China Sea and East China Sea. There is no mistaking the fact that, having enjoyed the benefits of an open global trading system supported by the United States, China has been building up military and other capabilities to challenge the United States. How should we respond? This is a weighty question that deserves far more attention from policymakers than it currently receives.

Today, China's leadership seems to have forgotten the critical role economic reform has played in China's own success story: The Xi Administration is focused on strengthening the government's grip on the economy, while eschewing needed economic reforms. Ultimately, for China's government, economic reform does not mean a freer market. Instead, it means that while some sectors of the economy will be subject to market discipline, the government—and, more importantly, the Chinese Communist Party—intends to retain control.

The worsening investment climate in China has been accompanied by rising censorship and tightening restrictions on freedom of information. Most recently, China has sought to control the activities of foreign nongovernment organizations (NGOs) through a newly passed NGO law.[47] The law gives Chinese authorities broad powers to close NGOs, requires foreign NGOs to register with the Chinese government, and empowers Chinese police to search a foreign NGO's finances and operations at any time.[48] China has also cracked down on Internet privacy and freedom of the press, with Roseann Rife, East Asia research director at Amnesty International, warning, "Chinese authorities are trying to rewrite the rules of the Internet so censorship and surveillance become the norm everywhere."[49]

Chinese government's efforts to censor content it finds objectionable are spilling over its borders. A Commission report released in October 2015 titled "Directed by Hollywood, Edited by China: How China's Censorship and Influence Affect Films Worldwide" details American filmmakers' increasing tendency to

edit films in anticipation of Chinese censors' potential sensitivities.[50] C. Robert Cargill, an American screenwriter, says Hollywood executives can either bend to China's demands or else "risk alienating one billion people … and risk the Chinese government going, 'Hey, you know one of the biggest film-watching countries in the world? We're not going to show your movie because you decided to get political.'"[51]

Members of Congress have a difficult task ahead of them in determining the future course of the U.S.-China economic relationship. Let me give you just one example: The United States and China are negotiating a Bilateral Investment Treaty (BIT), which the U.S. Senate would have to approve by a two-thirds majority. The BIT could increase U.S. investment in China and Chinese FDI in the United States—with potentially positive outcomes for the U.S. economy. However, a number of significant challenges complicate the debates around a prospective U.S.-China BIT. These include Chinese government's control over key sectors of its economy; Chinese policies granting preferential treatment to domestic companies, or forcing foreign companies to transfer technology in exchange for market access; and China's history of poor compliance with its international commitments.

With that in mind, I want to offer a few recommendations to ensure U.S. companies and workers continue to enjoy a level playing field.

- The USTR needs to be more assertive in bringing enforcement cases against China when it violates its WTO commitments. Companies are often reluctant to complain because they fear retribution from the Chinese government. Congress should therefore encourage the USTR to bring cases whenever U.S. interests are being hurt, even if U.S. companies will not speak up.

- U.S. policymakers should identify areas where stronger legal tools are needed to counter China's trade-distorting practices—including industrial policies, abusive legal or administrative processes, and discriminatory treatment of foreign investors—and implement them domestically and at the WTO. It is particularly important to focus on ensuring that small and medium enterprises, which often lack resources to pursue claims, have sufficient access to remedies if they have been negatively affected by Chinese trade-distorting practices.

- The United States should develop a more results-oriented approach to dealing with China's trade-distorting practices. We should identify our goals and pursue them in a comprehensive way—through dialogue and enforcement actions—setting specific, quantifiable commitments to keep China accountable.

- The United States should build coalitions with other trading partners to challenge China's unfair trade practices in multilateral fora and on a bilateral basis, including through the WTO. This approach was successful at convincing the Chinese government to suspend restrictive banking-sector IT guidelines which would have forced foreign suppliers to share source code with Chinese regulators. We should use it again to address other persistent challenges, including recent restrictions on the operations of NGOs.

Mr. Chairman, Ranking Member Brown, Members of the Committee, thank you again for the opportunity to be here today and to discuss the work the Commission is doing on behalf of Congress. I look forward to your questions.

Appendix: China's Strategic Sectors Identified in State Plans

Made in China 2025 (2015)	Strategic Emerging Industries (2010)	Strategic Industries (2006)	Heavyweight Industries (2006)
(1) Clean energy vehicles (2) Next-generation IT (3) Biotechnology (4) New materials (5) Aerospace (6) Ocean engineering and high-tech ships (7) Railway (8) Robotics (9) Power equipment (10) Agricultural machinery	(1) Clean energy technologies (2) Next-generation IT (3) Biotechnology (4) High-end equipment manufacturing (5) Alternative energy (6) New materials (7) Clean energy vehicles	(1) Armaments (2) Power generation and distribution (3) Oil and petrochemicals (4) Telecommunications (5) Coal (6) Civil aviation (7) Shipping	(1) Machinery (2) Automobiles (3) IT (4) Construction (5) Iron, steel, and nonferrous metals

Source: State Council of the People's Republic of China, *Made in China 2025*, May 8, 2015. http://www.gov.cn/zhengce/content/2015-05/19/content_9784.htm; U.S.-China Economic and Security Review Commission, *Hearing on China's Five-Year Plan, Indigenous Innovation and Technology Transfers, and Outsourcing*, written testimony of Willy C. Shih, June 15, 2011; U.S.-China Economic and Security Review Commission, *Hearing on the Extent of the Government's Control of China's Economy, and Implications for the United States*, written testimony of George T. Haley, May 24–25, 2007; and U.S.-China Economic and Security Review Commission, Chapter 1, Section 1, "The Relationship's Current Status and Significant Changes during 2007," in *2007 Annual Report to Congress*, November 2007, 38–39.

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PREPARED STATEMENT OF DESMOND LACHMAN, PH.D.

RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE *

JULY 14, 2016

Thank you Chairman Shelby, Ranking Member Brown, and Members of the Committee for affording me the honor of testifying before you today. My name is Desmond Lachman and I am a Resident Fellow at the American Enterprise Institute. I am here in my personal capacity and I am not here to represent the AEI's view on the subject under discussion.

Introduction

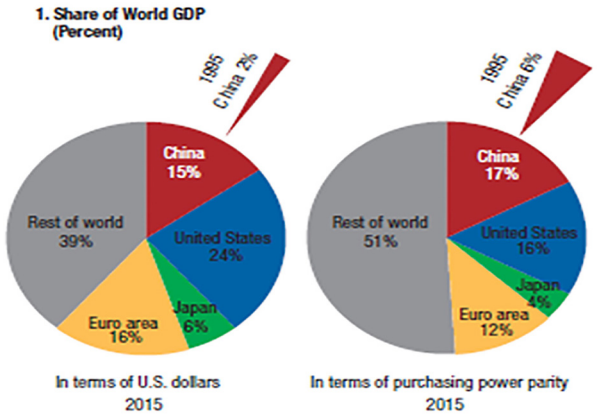
The Chinese economy, which is now the world's second largest economy and the world's largest trading nation, has become highly imbalanced as a result of an excessive reliance on credit creation and on investment-led growth. As a result, China's economic growth model is now showing every sign of having run its course. This has prompted the Chinese government to recognize the need for more balanced economic growth and has led it to significantly mark down China's long-term economic growth forecast.

It would be a mistake for U.S. policymakers to minimize the large adverse impact that a further slowing in the Chinese economy could have on the U.S. economy. Since a change in the economic fortunes in China could have a strongly adverse impact on the world economic outlook and on global financial markets. This would seem to be especially the case at a time that the world economy is drowning in debt and at a time that it is confronted with an unusual confluence of material downside risks. These latter risks include those emanating from last month's Brexit referendum, from the Brazilian economic and political crisis, and from the serious weaknesses now being revealed in the Italian banking sector.

China's growth model has become increasingly unbalanced

In assessing China's potential to impact the U.S. economic recovery, it is well to recall how important China has become to the global economy. Through two decades of very rapid, albeit unbalanced, economic growth, China's share in the world economy has increased from 2 percent in 1995 to 15 percent in 2015. This has made China the world's second largest economy ahead of Germany and Japan. In recent years, China, together with the other large emerging market economies, has been the principal engine for world economic growth. It was also a major factor in the super-international commodity price boom between 2008 and 2013, which drove strong economic growth in the world's major commodity exporting economies.

Figure 1: China's Role in the Global Economy



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

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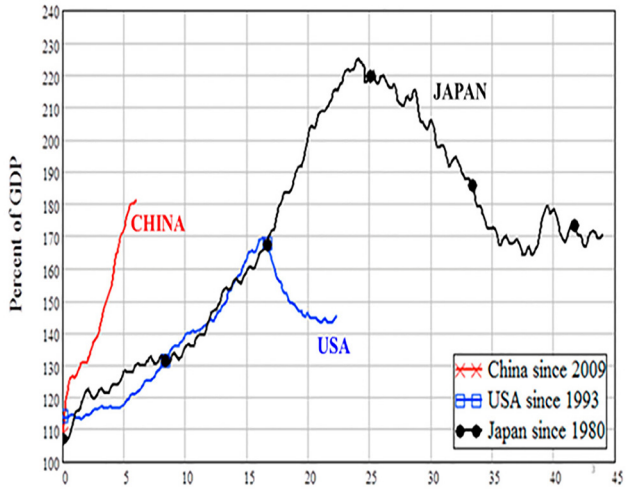
A primary concern about the Chinese economy is that it has relied excessively on an unbalanced and unsustainable economic growth model to drive its rapid economic growth. The unbalanced nature of the Chinese economy is most apparent from the fact that Chinese investment accounts for around 45 percent of China's GDP. It is also apparent from the fact that China has relied excessively on credit creation from its banking and shadow banking systems to drive economic growth and investment. Indeed, since 2009 Chinese credit to the nonfinancial private sector has increased by around 90 percent of China's GDP. Such a rate of credit expansion has been very much more rapid than that which preceded Japan's lost decade in the 1990s and that which preceded the U.S. housing bust in 2007.

Figure 2: Private Debt Bubbles



Source: BIS, IMF

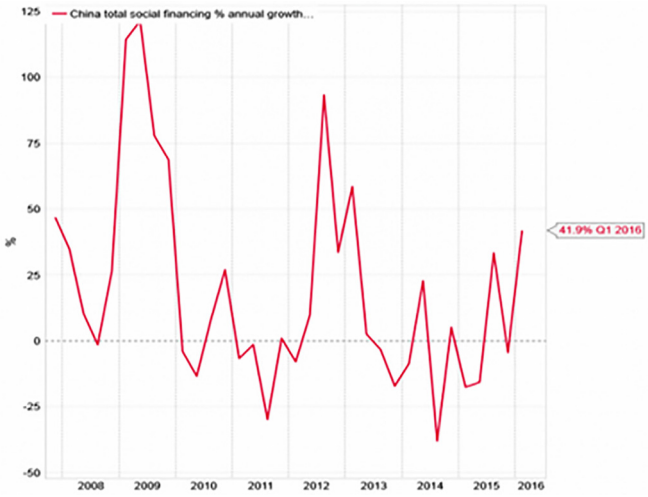
The excessive degree of Chinese investment and credit creation has given rise to a tremendous misallocation of resources. Many sectors of Chinese industry, including most notably the steel and construction sectors, are now characterized by massive excess capacity. In addition, excessive credit creation has spawned bubbles in the Chinese property and equity markets. Those excesses are now apparent in ghost towns and see-through commercial properties in many Chinese second-tier cities.

As the excesses in China's economy have started to be unwound, Chinese economic growth has slowed markedly from its former double digit rates. According to Chinese official estimates, real Chinese GDP growth has now slowed to below 7 percent and is expected to remain between 6½ and 7 percent over the next few years. However, many respected private sector analysts estimate that the Chinese economy may have already slowed to around 4 percent. Those analysts are justifiably fearful that China's economic growth will remain low as it transitions to a more balanced economic growth model.

Delaying Reforms

The present Chinese Administration appears to fully recognize the imbalanced nature of the Chinese economy and of the need to promote economic reforms that might make China a more consumer and service driven economy. To that end, the Administration has vowed to rebalance demand and to eliminate China's debt addiction before the country reaches its debt capacity limits. It has done so with the goal of achieving a more balanced and sustainable economic growth model.

Figure 3: Borrowing in China is growing fast again

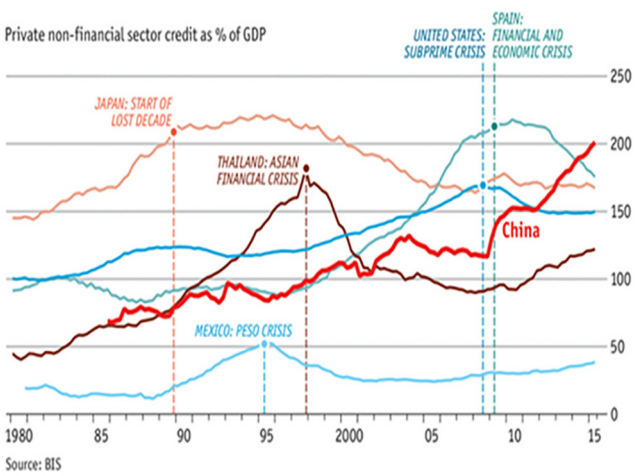


While President Xi Jingxing's administration has adopted certain measures toward reforming the economy, it is far from clear that it is fully committed to addressing China's credit addiction and to curbing its shadow banking system. Indeed, official data reveal that, in response to a slowing Chinese economy, the People's Bank of China has permitted yet another burst of credit as reflected in a more than 40 percent increase in such credit for the first quarter of 2016. More recently, however, Chinese credit growth appears to be being reigned in again.

Precedents from other credit bubbles

The extraordinary increase in Chinese private nonfinancial sector credit over the past 8 years has been at a pace that exceeds those that have preceded other major economic and financial crises. These crises include Japan's lost decade in the 1990s, the Mexican peso crisis in 1994, the Thai financial crisis in 1997, and the U.S. housing bust in 2007. Those earlier crises would all suggest that the current Chinese credit bubble will not end well and that the world should brace itself for a prolonged period of relatively slow Chinese economic growth.

Figure 4: Comparable Credit Bubbles

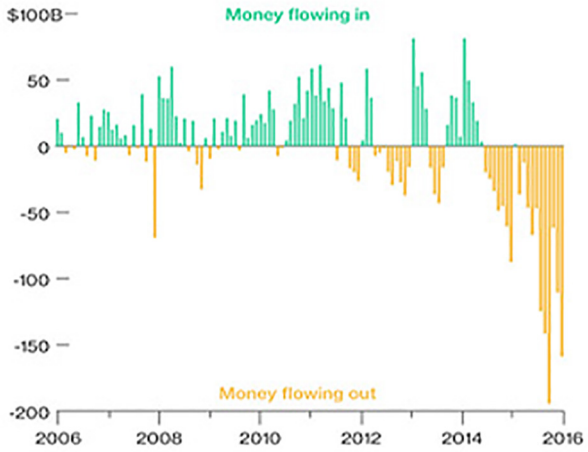


The fact that China's banking system is dominated by four state-owned banks makes it unlikely that China will experience an abrupt credit event like that which occurred in Asia during the late 1990s or in the United States in 2008. Rather, what is more likely is that the Chinese banking system will become increasingly clogged with nonperforming loans and with loans to zombie Chinese public and private sector companies along the lines that has occurred in Japan over the past two decades. This is very likely to keep China on a very low growth path for an extended period of time.

China's capital flight problem

Beyond the prospect of a slowing domestic economy, China's present capital outflow problem could pose a further risk to the global economy. During 2015, private capital outflows from China amounted to almost U.S.$700 billion in the wake of China's decision to move toward a more flexible exchange rate in August 2015 and of the correction of China's equity and property market bubbles. While China still has more than U.S.$3 trillion in international reserves, it is clear that China cannot sustain its recent pace of capital outflows for too long a period.

Figure 5: Chinese Capital Flows



Over the past few months, capital outflows from China have moderated as capital controls have been tightened and as the Chinese currency has stabilized. However, there is a considerable risk that China may feel obliged to again weaken its currency to stimulate export growth particularly in the context of a rising U.S. dollar in the wake of the Brexit vote. The experience of August 2015 would suggest that any significant move to a more depreciated renminbi against the U.S. dollar could again renew capital outflows.

Implications for the United States economy

It would be a mistake for U.S. policymakers to minimize the large adverse impact that a setback in the Chinese economy could have on the U.S. economy. Since a change in the economic fortunes in China could have a strong impact on the world economic outlook and on global financial markets. This would seem to be especially the case at a time that the world economy is drowning in debt and at a time that it is confronted with an unusual confluence of material downside risks

In assessing the financial and economic risks from China, it is important to distinguish between the direct and indirect impacts that a slowing in the Chinese economy might have on the U.S. economic outlook. In that respect, it would seem that a further Chinese economic slowing should not have a material *direct effect* on the U.S. economy. After all, China accounts for only around 7 percent of total U.S. exports or less than 1 percent of U.S. GDP. Similarly only 2 percent of U.S. enterprises' net income is derived from China while U.S. bank exposure to China only amounts to around 1 percent of the U.S. banking system's balance sheet.

By contrast, the U.S. economy could be *indirectly* affected in a major way by a further Chinese economic slowing through the effect that such a slowing might have on the rest of the world economy and on global financial markets. This might occur through three distinct channels:

a. First, a slowing in the Chinese economy would have a significant impact on the exports of China's Asian trading partners and of countries like Germany, which are very much more dependent than is the United States on the Chinese economy for their exports. As such, it could materially affect the global economic outlook confronting the United States.

b. Second, China might be forced to make use of its exchange rate to bolster its flagging economy especially if it continues to suffer from capital outflows. This could result in tensions in global currency markets where all too many countries are seeking to cheapen their currencies.

c. Third, a slowing Chinese economy must be expected to keep international commodity prices low for a protracted period of time. This has the potential to deepen the political and economic crises already being experienced in major commodity exporting emerging market countries like Brazil, Russia, and South Africa.

Two further considerations would argue that there should be no room for complacency in U.S. policymaking circles about the Chinese economic outlook. The first is that the three channels by which China could affect the global economy are all too likely to play out simultaneously. That would only amplify their negative impact on the global economy. The second is that a further Chinese economic slowdown could trigger other major fault lines in the global economy in countries like Brazil, Italy, Japan, and Russia. That too would argue against being overly complacent about potential Chinese economic developments at this delicate juncture in the global economic cycle.

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HEARING ON EVALUATING THE FINANCIAL RISKS OF CHINA
JULY 14, 2016

Chairman Shelby, Ranking Member Brown, and members of the Committee, thank you for your invitation to appear today to discuss the financial risks of China and in particular to provide you with an illustration of how the state-run nature of the Chinese economy has impacted the U.S. steel industry. I am Tom Gibson, President and CEO of the American Iron and Steel Institute. AISI serves as the voice of the North American steel industry in the public policy arena and advances the case for steel in the marketplace as the preferred material of choice. AISI is comprised of 19 producer member companies, including integrated and electric furnace steelmakers, accounting for approximately 70 percent of U.S. steelmaking capacity with facilities located in 41 states, as well as Canada and Mexico, and approximately 125 associate members who are suppliers to or customers of the steel industry.

I. State of the U.S. Steel Industry

The steel industry in the United States is currently suffering from a dramatic surge in imports from a number of countries around the world, many of which are dumped and subsidized. Finished steel imports increased by 36 percent in 2014 and captured a record 28 percent of our steel market. In 2015, as apparent steel demand in the United States decreased by over 10 percent, the share of the market taken by imports increased further to a new record of 29 percent. See Appendix Figure 1.

As a result of the large increase in import market share in 2014 and 2015, domestic steel shipments declined by 12.2 percent in 2015. Capacity utilization in the industry averaged just 70.1 percent for 2015, and the industry continues to operate at only 72.4 percent capacity utilization in the first half of 2016. See Appendix Figure 2. The seriousness of the import crisis affecting the U.S. industry is demonstrated by the fact that several steel companies have been forced to temporarily close major steel-making facilities, including mills in Fairfield, Alabama, Ashland, Kentucky and Granite City, Illinois, as well as a number of iron ore mines in Minnesota. Bureau of Labor Statistics data indicates that employment in the steel industry has declined by approximately 13,900 jobs since January 2015.

II. Global Steel Overcapacity Major Cause of U.S. Import Crisis

A recent analysis by the OECD shows that the global excess steel capacity in 2015 was estimated to be about 700 million metric tons.[1] The overcapacity crisis plaguing the global steel industry is largely a result of foreign government interventionist policies and practices. As the Department of Commerce found in 2000 in connection with the steel import crisis of the late 1990s and early 2000s, "government practices and policies that forestall adjustments mandated by the market" are a major cause of excess capacity in the steel industry.[2] This remains true today, as many governments continue to subsidize the start-up of additional, unnecessary capacity and prevent obsolete capacity from closure.

III. The Role of China in the Global Steel Crisis

Since 2000, Chinese government industrial and trade policies have produced a dramatic increase in the size of the Chinese steel industry, to the point that it today represents almost half of all global steel production.[3] Chinese crude steel production soared from 128 million MT in 2000 to 823 million metric tons (MT) in 2014 – an increase of 695 million MT – before declining slightly to 804 million MT in 2015.[4] See Appendix Figure 3.

For many years Chinese steel consumption was increasing, and in recent years a significant portion of China's excess steel production was absorbed by the Chinese government's stimulus spending on fixed asset investment. But Chinese steel demand appears to have peaked in 2013. The World Steel Association has reported that Chinese steel consumption (apparent steel use) declined by 3.3 percent in 2014[5] and by 5.4 percent in 2015.[6] See Appendix Figure 4. Furthermore, the demand situation in China is expected to worsen over the coming decade. The POSCO Research Institute forecasts

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[1] OECD, The Capacity Outlook for the Global Steel Industry: Preliminary OECD Estimates, *presented at* worldsteel ECON meeting, Madrid, 9 September 2015.

[2] U.S. Department of Commerce, International Trade Administration, Report to the President, Global Steel Trade: Structural Problems and Future Solutions (July 2000) ("Commerce Global Steel Trade Report") at 4.

[3] World Steel Association, "World crude steel output decreases by -2.8% in 2015," January 25, 2016.

[4] *Id.* World Steel Association, "Monthly Crude Steel Production 2015"; World Steel Association, "Monthly Crude Steel Production 2000."

[5] World Steel Association, 2015 Short Range Outlook, *found at* *http://www.worldsteel.org/dms/internetDocumentList/press-release-downloads/2015/Short-Range-Outlook-table-by-Region-2015-2016-12Oct2015/document/Short%20Range%20Outlook%20table%20by%20region%202015-2016.pdf.*

[6] World Steel Association, 2016 Short Range Outlook, *found at* https://www.worldsteel.org/dms/internetDocumentList/press-release-downloads/2016/Short-Range-Outlook-Table-by-Region-2016-2017/document/Short%20Range%20Outlook%20Table%20by%20Region%202016-2017.pdf

that steel demand in China will decrease steadily until 2025, due to the slowdown in the Chinese construction and manufacturing industries.[7]

With China's domestic steel demand declining, the Chinese steel industry has increasingly relied on exports to consume surplus production. China exported a record 94 million MT of steel products in 2014, an increase of 52 percent from 2013.[8] That trend accelerated in 2015 with Chinese steel exports rising to 112 million MT, "an amount big enough to feed demand in Germany and Japan for a year and leave almost 9 million metric tons to spare."[9] Through May 2016, Chinese producers exported 46.3 million MT of steel to the world,[10] and when annualized at 111.1 million MT, will nearly match the record export levels in 2015.

This increase in Chinese exports to the world has resulted both in increased imports of Chinese steel into the United States and in increased imports from third countries that have themselves received increased Chinese steel imports. In some cases, Chinese steel imports in third countries are being further processed into downstream steel products that are then exported to the United States. For example, Chinese billets may be further processed in Turkey into long products which are then exported to the United States, while Chinese flat-rolled steel may be converted into pipe products in Korea which are then exported to the U.S. market. The increase in Chinese steel production cannot be explained by associated market forces and has caused the U.S. industry significant injury.[11]

A. Capacity Growth is Not Supported by Profitability

In addition to the excess steel capacity growth not being supported by demand, it is also not supported by profitability. The low profits of steel companies worldwide also illustrate the disconnect between steel capacity growth and market forces. [12] The Chinese steel industry provides the best example of this as China's dramatic increase in steel capacity has occurred despite financial returns that are well below those achieved by other steel industries, and even other industries in China. "China's steel industry has one of the lowest operating margins compared not only to the steel industries of many other economies but also relative to other domestic industries. China's steel industry is ranked 85th out of 94 Chinese service and manufacturing sectors, but is last amongst all

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[7] POSCO Research Institute, *Asian Steel Watch* (January 2016) at 99-103.

[8] Ruby Lian and David Stanway, "Chinese Steel Exports to Stay High This Year - Industry Group," Reuters (Apr. 29, 2015).

[9] "China's steel exports now outstrip demand in any other country" Bloomberg (Jan. 13, 2016), *found at http://www.mineweb.com/news/iron-and-steel/chinas-steel-exports-now-outstrip-demand-in-any-other-country.*

[10] "China's Steel Exports Rise, Defying Japan, U.S. Call for Curb" Bloomberg (June 8, 2016), *found at http://www.bloomberg.com/news/articles/2016-06-08/china-s-steel-exports-climb-after-mills-ramp-up-output-to-record*

[11] Wiley Rein LLP Report "Unsustainable: Government Intervention and Overcapacity in the Global Steel Industry" (April 2016) at 11, available online.

[12] *Id at* 12.

domestic manufacturing industries."[13] China's major steel firms reportedly lost more than $15.5 billion last year alone, and many believe the actual figures are likely much greater. Additionally, the debt ratio of China's major steel mills is reported to have risen by 1.6 percentage points in 2015 to 70.1 percent, bringing the total debt of only the country's "big mills" to $499 billion, while another estimates that "the Chinese steel industry has roughly $520 billion in total debt held largely by Chinese [state-owned] banks."[14] China is creating a massive, growing and unsustainable debt bubble which is linked to the government interventions and practices that have led to its enormous excess steel capacity.[15]

Unlike a market-based company, Chinese companies can run these massive debts because the Chinese government will often direct the banks to continually refinance the debt, and "ultimately sweep it off the books and into "asset management companies" or other state-created financial firms designed exclusively to absorb bad corporate debts and cover losses in Chinese enterprises."[16] For its own sake and that of the global economy, China really needs to implement steps to promote the exit of overcapacity and to deflate the country's debt bubble, before the world economy becomes even more vulnerable to a massive Chinese debt crisis. The steel industry should be viewed as an example of what can happen to the broader global economy if China does not address its market distortions. These non-market based decisions and the resulting overcapacity and massive exports have severely hindered the ability of steel producers around the world to operate profitably, tanking the world steel market.[17] Market oriented steel producers make decisions based on commercial considerations where earning profits and a decent return on capital is essential, that cleary is not the case for Chinese steelmakers. "In short, the overwhelming majority of global capacity increases since 2000 have occurred in what has become the least profitable steel industry in the world, highlighting the disconnect between profitability and growing capacity. Despite increasingly nonexistent profits, Chinese steel producers continue to boost production and add capacity largely as a result of governmental control over and intervention in the industry."[18]

B. Overcapacity Driven by Government Policies

China leads the world not just in capacity increases, but in *excess* capacity levels. China's official steel capacity levels reached 1,160 million metric tons in 2014,[19] meaning it had excess capacity of at least 337 million metric tons. CISA estimates that there is

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[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id* at 12-13.
[17] *Id* at 13.
[18] *Id.*
[19] The Ministry of Industry and Information Technology (MIIT) announced Chinese capacity of 1.16 billion metric tons (1.277 billion net tons) in 2014. Chinese steel production in 2014 was 823 million MT.

even more steelmaking capacity in China than the official government statistics report - approximately 1.25 billion metric tons of crude steel production capacity in China in 2014, compared with 823 million metric tons of actual production in 2014. That equals more than 425 million metric tons of excess capacity[20] out of OECD's estimated global total of 700 million metric tons.

While China is not the only source of the overcapacity problem, AISI believes that overcapacity in China is the greatest challenge facing the global steel industry today and is a significant factor in the surge in steel imports into the U.S. market in the past several years.

Additionally, China provides the most striking example of government intervention in the steel industry, which has resulted in the enormous growth in steel capacity discussed above. The unprecedented growth in Chinese capacity is largely a result of massive government ownership and control over the steel industry, at the expense of market-oriented steel producers around the globe.[21]

Nine of the ten largest steel producers in China are state-owned and the top two produced more steel in 2014 than the entire U.S. steel industry. The Chinese government owns and controls most of its major steel producers intervening extensively in their operations. For instance, reports often surface that indicate local Chinese governments will direct their steel mills to increase their exports and foreign exchange earnings regardless of their order books. Similarly, we also know that the Chinese government often intervenes to prevent the closure of capacity. Many older mills in China, which would likely close in a purely market-based environment, have been supported by local governments and continue to operate, intensifying global oversupply. It is the Chinese government's significant involvement in its steel industry that has contributed to both the enormous increases in new capacity and the prevention of the closure of inefficient capacity.[22] Through various laws, policies, and industrial plans, the Chinese government for decades has directly subsidized its steel industry through the provision of grants, preferential loans, debt-for-equity swaps, tax refunds, and other preferential policies, as well as various forms of indirect support, such as

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[20] China Iron and Steel Association (中国钢铁协会), *Analysis of Key Points for the Development of Steel Enterprises in the Thirteenth Five Year Plan Period* (钢铁企业"十三五"发展重点分析) (Mar. 19, 2015), http://www.chinaisa.org.cn/gxportal/DispatchAction.do?efFormEname=ECTM40&key=AmEIN1oxUDFRMAI1A2QHZg1pAGBRNVVjAzRSYAVnBDMGFQ9ADhVVZQMSD0hVQgVn.

[21] *See, e.g., Perverse advantage: A new book lays out the scale of China's industrial subsidies*, The Economist (Apr. 27, 2013) ("On their conservative calculations, China spent over $300 billion, in nominal terms, on the biggest SOEs between 1985 and 2005. This help often came in the form of cheap capital and underpriced inputs unavailable to international rivals … Such distortions breed indiscipline and overcapacity… A similar problem looms in the steel industry, where the country's excess capacity of some 200m tonnes surpasses the entire capacity of Japan's steelmakers.").

[22] Wiley Rein LLP Report "Unsustainable: Government Intervention and Overcapacity in the Global Steel Industry" (April 2016) at 14.

restrictions on foreign investment.[23] The Chinese government has created the world's largest steel industry[24] because of these types of policies and its significant ownership stakes.

IV. State Ownership and Control of Financial Institutions in China

A number of the world's largest banks measured by market capitalization are based in China, "yet these banks are conspicuously absent from most of the world's markets for financial services." This is "symptomatic of the non-market foundation for China's financial system" and suggests the real objective function of China's massive financial institutions is to serve "the needs of national economic development." Contrary to the market-oriented nature of many of the largest banks headquartered elsewhere in the world, China's banks "appear to have little interest in expanding into new, foreign markets for financial services—except, perhaps, to provide financial services in support of SOEs that are "going out" with direct investment in overseas markets."[25]

For example, China's official government system of export financing is supplemented by lending from commercial banks that are owned or otherwise controlled by the government.[26] The China Development Bank is directed to extend loans that are consistent with the goals of China's economic plans, which include producing "national champions," in sectors like steel, that are able to compete on a global scale.[27] In addition, the China Export and Credit Insurance Corporation ("SINOSURE") was created in 2001 to "fulfill the Chinese government's diplomatic, international trade, industrial, fiscal and financial policies."[28]

"The Chinese state directly owns the vast majority of the country's financial institutions—its banks, brokerages, insurance, and investment firms"—and is also the largest actor in China's financial markets. It owns a controlling majority of corporate shares in publicly listed companies and dominates "origination and trading of financial assets in bonds, derivatives, and foreign exchange markets."[29]

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[23] *See generally* Wiley Rein & Fielding LLP, *The China Syndrome: How Subsidies and Government Intervention Created the World's Largest Steel Industry* (July 2006); Wiley Rein LLP, *The Reform Myth: How China Is Using State Power to Create the World's Dominant Steel Industry* (Oct. 2010).

[24] Wiley Rein LLP Report "Unsustainable: Government Intervention and Overcapacity in the Global Steel Industry" (April 2016) at 14.

[25] Adam S. Hersh, "Is China a Market Economy? Making Progress but still falling short of international norms for the global marketplace" (2015) at 18.

[26] Anna Tucker, "Export Assistance and the China Challenge," *USCC Staff Research Backgrounder* (Apr. 27, 2012) ("Export Assistance and the China Challenge") at 4.

[27] *Id.*

[28] *Id.*

[29] Adam S. Hersh, "Is China a Market Economy? Making Progress but still falling short of international norms for the global marketplace" (2015) at 19.

V. Chinese Currency Manipulation

AISI members, along with other U.S. manufacturers, have long expressed concern over China's policy of controlling the exchange rate between its currency (known as the renminbi ("RMB") or the yuan) and the U.S. dollar.[30] In February 2014, the Economic Policy Institute performed an analysis of the impact of currency manipulation of the yuan and other currencies that remain undervalued to compete with the yuan.[31] This analysis showed that the elimination of currency manipulation would reduce the U.S. trade deficit between $200 billion and $500 billion in three years.[32] This would increase annual U.S. GDP by between $288 billion and $720 billion (between 2.0 percent and 4.9 percent).[33] The reduction of the U.S. trade deficit and expansion of U.S. GDP would create 2.3 million to 5.8 million jobs, reducing the U.S. jobs deficit by between 28.8 percent and 72.5 percent.[34] Other recent analyses have likewise recognized the harmful impact of China's currency manipulation.[35]

On August 11, 2015, China's central bank devalued the yuan by 1.9 percent, while simultaneously announcing a change in the calculation of the yuan's daily trading band. This caused the value of the currency to fall nearly 3 percent against the dollar, the largest two-day drop in 20 years.[36] Under the new rules, the mid-point for the value of the yuan would be set utilizing the previous day's closing value. While Beijing claims the devaluation was a result of an effort to move towards a more market-determined exchange rate, many observers claim it was likely meant to boost China's export economy which had declined in recent weeks.[37] It is our view that there is every indication that China has no intention of ending the manipulation of its currency.

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[30] In 2004, for example, AISI joined a coalition of U.S. industrial, service, agricultural, and labor associations seeking relief under Section 301(a) of the Trade Act of 1974, as amended, from China's manipulation of the renminbi. Petition for Relief under Section 301(a) of the Trade Act of 1974 on behalf of the China Currency Coalition (Sept. 9, 2004), *available at* http://www.aflcio.org. This petition demonstrated that China's exchange-rate policy constitutes a prohibited export subsidy within the meaning of Articles 1, 2, and 3 of the SCM Agreement and Articles VI and XVI of the GATT 1994. *Id.* at 50.

[31] *See* Robert E. Scott, "Stop Currency Manipulation and Create Millions of Jobs," *Economic Policy Institute* (February 26, 2014) ("Stop Currency Manipulation").

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] *See, e.g.*, C. Fred Bergsten, "Currency Wars, the Economy of the United States, and Reform of the International Monetary System," *Peterson Institute for International Economics* (May 16, 2013) ("Currency Wars") at 5 (finding that currency manipulation is responsible for up to $500 billion of the U.S. trade deficit and the loss of up to 5 million U.S. jobs); Lawrence Edwards and Robert Z. Lawrence, *Rising Tide: Is Growth in Emerging Economies Good for the United States?* Peterson Institute for International Economics (2013) at 83 (concluding that currency manipulation was responsible for the loss of 2.7 million jobs in 2010).

[36] CNN Money, "Yuan Tumbles for Second Day as China Devalues," (Aug. 12, 2015)

[37] *Id.*

While we recognize and appreciate the changes that Congress made in the recently enacted Trade Facilitation and Trade Enforcement Act of 2015 with respect to Treasury's reporting requirements in its biannual report on exchange rates, AISI believes the U.S. government could take far more aggressive and creative action on this important issue. A number of proposals have been put forward in this regard but one that Congress could act on now is Senator Sessions' and Brown's bill, S. 433, the Currency Undervaluation Investigation Act, which has the support of many on this Committee and would explicitly provide the Administration with the authority to treat currency manipulation of the type practiced by China as actionable under U.S. trade remedy laws.

VI. Role of Multilateral Development Banks

The activities of multilateral development banks and national export promotion agencies have exacerbated the government interference in the global steel market. These organizations have loaned steelmakers around the world billions of dollars, often ostensibly to increase energy efficiency, to reduce pollution, and even to promote the export of steelmaking machinery. Regardless of the goal, the end result is the same – lending at below-market rates which leads to the creation and maintenance of capacity that would not otherwise occur, fueling the overcapacity crisis.[38]

VII. Policy Recommendations

In order to mitigate some of the causes of the global crisis in the steel sector and provide relief to domestic industry, AISI recommends the following:

1. Vigorously enforce U.S. trade laws. As a first step, it is essential that the U.S. government use all means available under our trade laws to provide immediate relief to the U.S. Industry from the injurious effects of the surge in imports into the U.S. market in recent years. In pending and future antidumping and countervailing duty investigations on steel products, the Department of Commerce should use all tools available under the trade laws, including the improvements made to these laws by Congress last year in the Leveling the Playing Field Act enacted as part of the TAA legislation, to offset the full amount of dumping and subsidization currently benefitting unfairly traded imports under investigation. Likewise, Customs and Border Protection (CBP) should also use all the tools made available under the recently enacted ENFORCE Act to prevent and address any and all instances of evasion of existing and new AD/CVD orders on steel products.

The Administration must also continue to treat China as a non-market economy for antidumping purposes and not give in to Chinese demands that it be automatically graduated to market economy status in December 2016.

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[38] Wiley Rein LLP Report "Unsustainable: Government Intervention and Overcapacity in the Global Steel Industry" (April 2016) p. 21.

2. Congress should pass S. 433, the Currency Undervaluation Investigation Act, which would explicitly provide the Administration with the authority to treat currency manipulation of the type practiced by China as actionable under U.S. trade remedy laws.

3. Work with the Administration to secure commitments by other countries to eliminate steel overcapacity. AISI appreciates the continued efforts of the U.S. government to make addressing the steel overcapacity issue a priority by having it on the agenda at a number of recent high-level meetings including the G7 Summit in Japan, the U.S.-China Strategic and Economic Dialogue (S&ED), and the North American Leaders Summit. Given how much of the steel overcapacity resides in China it is critical that the Administration contine to engage China at the highest levels. While Chinese leaders made commitments at the S&ED meeting to adopt measures to: strictly contain steel capacity expansion; reduce net steel capacity; eliminate outdated steel capacity; and dispose of 'zombie enterprises' through restructuring, bankruptcy and liquidation, these commitments will only be meaningful if they lead to real results that produce a significant net reduction in excess steel capacity in China. For example, we remain concerned that prior Chinese government commitments to reduce capacity by 100 to 150 MT, repeated by China at the recent S&ED, are not sufficient given the size of the problem. This would require the net elimination of 337-425 million MT of excess capacity in China. Likewise, China has failed to specify how it proposes to achieve these reductions.

Promises of future action to reduce capacity by China and other governments are not enough, as there have been instances in the past where capacity reduction plans were offset by new capacity additions, especially in China.

While action by China is critical, the Administration should also seek such commitments by other countries that have relied on government policies to subsidize the development of new steel making capacity in recent years and should pursue those efforts at the OECD.

4. Work with the Administration to secure commitments by all steelmaking countries to eliminate and not introduce subsidies and other market-distorting policies related to steel. The Administration should seek commitments by all major steelmaking nations to eliminate current market-distorting subsidy programs specific to the steel sector and to refrain from introducing new subsidy programs in the future. These commitments must apply not only to central governments, but also to provincial/state and local programs. As this should be a common goal of all

steelmaking nations, AISI supports U.S. federal, state and local governments being bound by the same commitments.

5. **Impose a strict prohibition on multilateral and export bank lending on steel projects,** which has been a significant source of funding for unnecessary capacity survival and expansions.

VIII. Conclusion

The U.S. steel industry has been severely impacted by the surge in dumped and subsidized imports that have flooded the U.S. market in recent years. This surge is the result of foreign government interventionist policies in the steel sector that have fueled massive and growing global overcapacity in steel, particularly in China. AISI therefore greatly appreciates the attention being given by the Administration and Congress to the global steel industry crisis and its impact on the U.S. industry, and urges you to work with us to secure commitments from China to eliminate steel overcapacity and its market-distorting policies and practices, while vigorously enforcing our existing trade laws.

APPENDIX

Figure 1: U.S. Finished Steel Import Volume and Market Share

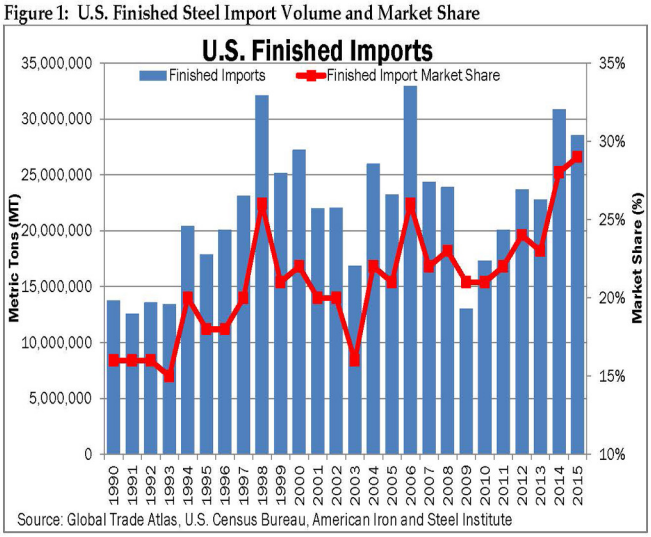

Figure 2: U.S. Raw Steel Making Capacity Utilization

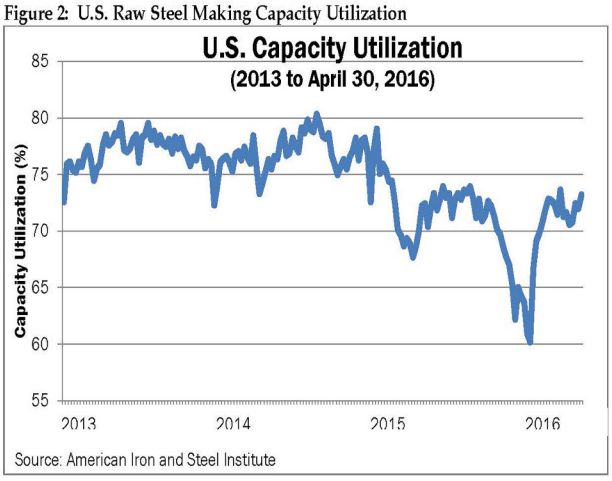

Figure 3: Chinese Steel Production vs. U.S. Steel Production

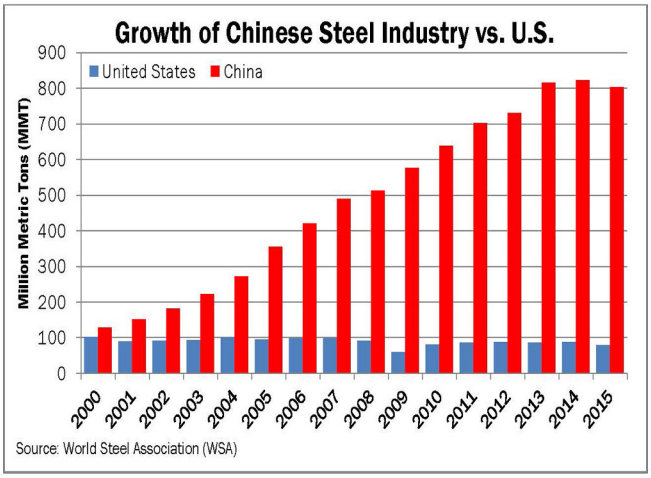

Figure 4: China Apparent Steel Use

Figure 5: Chinese Steel Exports

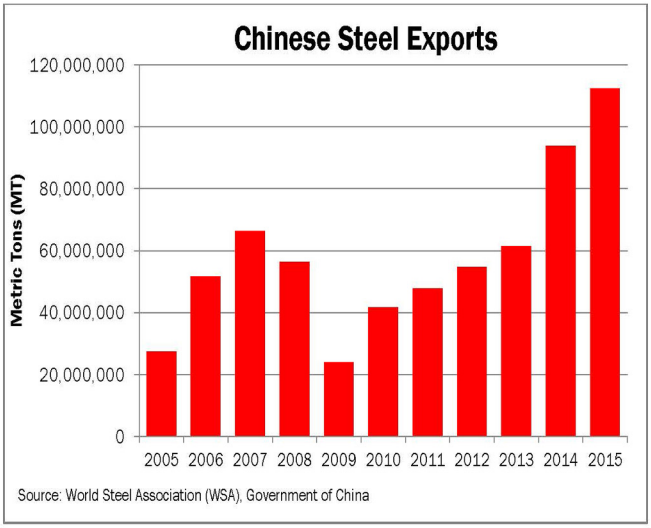

Figure 6: OECD Estimates of Global Steel Overcapacity

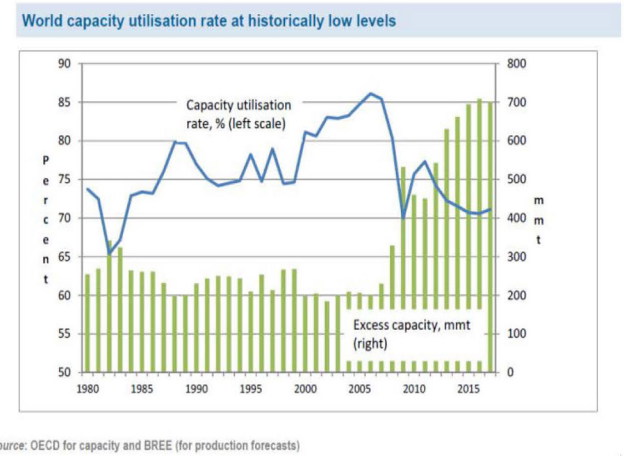

Figure 7: Top 10 Chinese Steel Producers – 9 of 10 are State-Owned

Firm	2014 Production (MMT)
Hebei Steel Group	47.1
Baosteel Group	43.3
Wuhan Steel Group	33.1
Shagang Group (Private)	35.3
Ansteel Group	34.3
Shougang Group	30.8
Shandong Steel Group	23.3
Tianjin Bohai Steel	18.5
Maanshan Steel	18.9
Benxi Steel	16.3
TOTAL	300.9

PREPARED STATEMENT OF WILLIAM T. WILSON, PH.D.

SENIOR RESEARCH FELLOW, THE HERITAGE FOUNDATION

JULY 14, 2016

My name is William Wilson. I am a Senior Research Fellow at The Heritage Foundation. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

Overview

Despite its size, direct global exposure to the Chinese financial system is currently still small. A regulatory wall around the Chinese financial system is largely responsible for this.

A financial crisis in China is likely to lead to a heighten level of capital flight. The Chinese authorities and central bank would be forced to offset downward pressure on the yuan-dollar exchange rate buy selling U.S. denominated assets (*i.e.,* primarily U.S. Treasuries). This, however, is unlikely to result in a significant fall in U.S. bond prices (*i.e.,* a rise in U.S. interest rates) given the dollar's solid safe-haven status in times of global financial crises.

Most of the fallout will be within Asia, where trading and lending have the strongest links and where credit has been growing the fastest globally since the 2008–2009 financial crisis.

The Current State of the Chinese Economy—A Brief Overview

There exists great skepticism about the accuracy of many Chinese macroeconomic indicators. There are significant reasons for this perception. First of all, any government exercising such a significant role in managing the direction of an economy is highly likely manipulating official statistics. In a nation of almost 1.4 billion people, quarterly gross domestic product (GDP) figures are often released just 14 days after the end of the quarter with no subsequent revisions. (In the United States, GDP figures undergo two revisions, sometimes significant, spanning out 60 days after the first release.)

The headline figures often conveniently match Beijing's target figure. To admit the economy was growing at a 4 percent pace could cause a loss in confidence in the relatively early 10-year tenure of Xi Jinping. There are plenty of inconsistencies. While GDP was reported to grow at a 6.8 percent in 2015, electricity consumption rose by only 0.5 percent. These two figures are simply not consistent.

More ominous has been the level of fixed-asset investment (*i.e.,* residential and commercial construction, physical infrastructure, *etc.*). While it has fallen very modestly as a share of GDP recently, since the global financial crisis, it has run at approximately 45 percent of GDP. Historically speaking, this level is unprecedented among the emerging market economies, even those in East Asia during their rapid growth periods.

This elevated level of fixed investment has long passed its expiration date. Many industries such as steel, cement, rare earth minerals, energy refining and housing are operating at three-quarters capacity. This is precisely why wholesale prices have fallen for three consecutive years.

A large drop in fixed-asset investment (as a share of GDP) will be a necessity. First, the return on these investments has been rapidly declining. The amount of capital needed to generate an extra dollar of income has more than doubled over the past decade. Even bringing this figure down to 30 percent of GDP is highly likely to produce significantly slower economic growth from current levels.

Reflecting the drop in overall efficiency, the contribution of total productivity to GDP has been falling in China. From 1991–2000 it averaged 5.9 percent then declined to an annual average of 3.6 percent during the past 5 years (2011–2015). To reach a GDP growth target of 5.5 percent to 6.5 percent per year, multifactor productivity growth will need to contribute to 40 percent to 50 percent of GDP growth moving forward.

China's Debt

China's total debt (household, corporate, government) is now much higher than in other developing economies and comparable to levels in the United States and the eurozone. While the size is a concern, what is more troubling is the speed at which debt has accumulated. It was approximately 150 percent of GDP in 2007 (a year before the crisis), and is now approximately 250 percent to 300 percent of GDP.

The economy's debt load has more than tripled over the past 7 years. New borrowing increased by Rmb 6.2 trillion in the first quarter of 2016, the largest 3-month increase on record.

Roughly two-fifths of new debt is swallowed by interest on existing loans. Less credit is going to good firms for productive uses.

Rising Defaults on the Way

It is impossible for China to deploy all the capital productively over a short period of time.

It now takes nearly four yuan of new borrowing to generate one yuan of additional GDP, up from just over one yuan of credit before the financial crisis.

Rising debt levels cause financial distress on borrowers which lead to slower growth before defaults even begin increasing.

China could experience a balance-sheet recession similar to Japan's. When corporate debt reaches a critical level, conventional monetary policy losses its effectiveness because companies focus on paying down debt instead of borrowing at lower interest rates.

Official data has nonperforming loans at just 1.7 percent of total loans. This figure grossly underestimates the current stock of "bad" loans.

One of Beijing's new strategies to handle this problem is a debt-equity swap, where banks could write off problem company loans in return for taking equity stakes in them.

Seeking to become less reliant on bank borrowing, Chinese corporations have aggressively tapped the bond market. At $900 billion, it is one of the largest in the world.

Approximately 85 percent of China's bond issuers have AA ratings or above by domestic rating agencies, compared to Moody which rates only 3 percent of global issuers so highly.

The Shadow Banking System

Five years ago, the Chinese shadow banking system was primarily driven by companies unable to secure traditional bank loans. Today, the driver is from ordinary people looking for higher rates of returns.

China's shadow banking system is estimated to be at least two-thirds of GDP. As long as banks do not guarantee the principal of these products, they do not have to report them on their balance sheets. In essence, they are a hidden balance sheet.

One big difference is that the government guarantees bank deposits while shadow lenders are supposed to stand on their own.

China's shadow banking system has become large, but until now, it has avoided creating products similar to the mortgage-backed securities like in the United States before the financial crisis. Banks with the largest shadow loans are mid-sized institutions. Wealth Management Products (WMPs) account for about 15 percent of deposits at the largest banks but over 40 percent at mid-tier banks.

Liquidity Issues

Banks are increasingly relying on short-term funding from the sale of high-yielding wealth management products instead of stable deposits. This funding can quickly evaporate when defaults rise. It is probably only a matter of time until banks are unable to fund all their assets safely.

Banks are becoming more reliant on WMPs, where they pay higher returns in lieu of short-term deposits and invest these in long-term assets. This causes a mismatch in duration. China traditionally restricted bank loans to less than 75 percent of their deposit base, but that figure is now approaching 100 percent.

The average maturity of WMPs is only 113 days, but bank loans have much longer maturities, meaning that banks are forced to constantly sell new WMPs for funding.

Global and U.S. Financial Exposure

Since the 2008–2009 global recession, China has accounted for roughly one-third of global economic growth, by far the highest in the world. With a GDP of roughly $11 trillion (current prices), the second largest in the world after the United States, any economic slowdown in this Asian juggernaut is bound to have enormous global consequences.

Since 2010, the rate of economic growth in China has decelerated from a 9.3 percent pace in 2011 to 6.8 percent in 2015 (and the accuracy of the latest figure is in serious question). The question is what impact a further slowdown in China would have on the U.S. economy.

There are three primary channels in which a significant slowdown in China could impact the U.S. economy. The first is through trade. In 2015, China was America's third largest export market, after Canada and Mexico, respectively. This was valued at $116.2 billion, a 50 percent increase since 2008. Exports to China accounted for 7.7 percent of total U.S. exports in 2015, not an inconsequential figure but not

devastating to U.S. export revenue in the event of a further Chinese stall in growth. (Chinese exports to the United States were $481 billion in 2015.)[1]

The second channel is financial. The Chinese are now the largest holder of U.S. debt (after Japan), standing at $1.2 trillion in April 2016. This currently represents 20 percent of total foreign holdings.[2]

In the event of a further slowdown in the Chinese economy, the government may want to sell some of these securities for economic stimulus. This could lead to a fall in U.S. bond prices (*i.e.,* a rise in domestic interest rates), depressing domestic investment. This impact has been discussed extensively and largely exaggerated for two reasons. First, the Chinese are unlikely to liquidate a large portion of their U.S. Treasury holdings because it might lead to a capital loss on their existing holding. Second, U.S. Treasuries are the most liquid and coveted securities in the world. In the event of an economic crisis, investors would flee toward Treasuries. The recent economic crisis illustrates this.

The third channel is largely a positive one. The slowdown in the Chinese economy has significantly depressed global commodity prices. Despite the shale oil revolution, the U.S imported 9.4 million barrels of petroleum per day in 2015. While the United States exported 4.8 million barrels per day in 2015, the net impact for the U.S. economy was positive.[3]

So what is the likely net impact? According to the Organization for Economic Cooperation and Development (OECD), a 2 percent decline in Chinese domestic demand growth will cause a decrease in U.S. GDP growth rate by approximately 0.3 percent.[4]

Bottom line? With an economy cruising along at a lackluster 2 percent rate of growth, this drop is not insignificant but also not traumatic.

In terms of the Chinese economy, if the past 7 years have taught us anything, it is that financial crises typically result in a period of protracted slow growth. It already appears that China may be entering the early stages of this correction. How the Chinese Communist Party reacts to it will change the future of global geopolitics.

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[1] U.S. Census Bureau, "Top Trading Partners—December 2015)," *https://www.census.gov/foreign-trade/statistics/highlights/top/top1512yr.html* (accessed July 12, 2016).

[2] U.S. Treasury, "Major Foreign Holders of Treasury Securities (in billions of dollars)," June 15, 2016, *http://ticdata.treasury.gov/Publish/mfh.txt* (accessed July 12, 2016).

[3] U.S. Energy Information Administration, "Frequently Asked Questions," April 1, 2016, *http://www.eia.gov/tools/faqs/faq.cfm?id=727&t=6* (accessed July 12, 2016).

[4] Elvin Mirzayev, "Impact of the Chinese Economy on the U.S. Economy," Investopedia, July 29, 2015, *http://www.investopedia.com/articles/investing/072915/impact-chinese-economy-us-economy.asp* (accessed July 12, 2016).

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN SHELBY FROM DENNIS C. SHEA †

Q.1.a. In your oral testimony, you stated that food security is a matter for which the United States needs to pay close attention. This is an issue that attracts increased attention within Congress with each passing Chinese agricultural acquisition.

Do you find that China's attempts to integrate its strategic sectors vertically and horizontally, by coordinating the activities of its state-owned enterprises while deploying state resources to target key global industries and non-Chinese companies, to significantly influence China's foreign investment decisions in United States agriculture and to negatively affect its food security concerns?

A.1.a. At present, there is no evidence of an excessive Chinese presence in the U.S. food supply chain. However, because Chinese state-owned enterprises (SOEs) are encouraged to invest abroad in what the Chinese government considers "strategic" industries, continued Chinese investment in the U.S. agriculture sector should be closely monitored. Several recent investments illustrate how the Chinese government utilizes foreign investment to develop the country's domestic agriculture sector. In September 2013, a subsidiary of the Chinese meat processing company Shuanghui Group ‡ acquired U.S. pork producer Smithfield Foods Inc. for $4.7 billion.[1] Then, in August 2016, the state-owned China National Chemical Corporation (ChemChina) finalized a $43 billion bid to buy Syngenta AG, one of the world's largest producers of crop protection products, including pesticides, fungicides, and genetically modified seed.[2]

Q.1.b. Should the various current U.S. review processes, including that of the Committee on Foreign Investment in the United States, take into account the accumulative percentage of market control by all Chinese state-owned enterprises currently operating within the U.S. agriculture sector, not just the immediately acquiring entity, when reviewing transactions involving Chinese state-owned enterprises?

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† Please note the responses here represent my own views and not necessarily those of the Commission itself or other members of the Commission.

‡ Shuanghui Group is privately owned, but has received substantial support from the Chinese government. In a September 2014 interview with the Public Broadcasting Service (PBS), Shuanghui's president, Zhang Taixi, explained that the Chinese government had been "very supportive" of the Smithfield acquisition, offering preferential policies and financing from state banks to support the deal. PBS Newshour, "Who's Behind the Chinese Takeover of World's Biggest Pork Producer?" September 12, 2014. *http://www.pbs.org/newshour/bb/whos-behind-chinese-takeover-worlds-biggest-pork-producer/*.

[1] Smithfield Foods, "Shuanghui International and Smithfield Foods Complete Strategic Combination, Creating a Leading Global Pork Enterprise," September 26, 2013. *http://www.smithfieldfoods.com/newsroom/press-releases-and-news/shuanghui-international-and-smithfield-foods-complete-strategic-combination-creating-a-leading-global-pork-enterprise.*

[2] China National Chemical Corporation, "ChemChina and Syngenta Receive Clearance from the Committee on Foreign Investment in the United States (CFIUS)," August 22, 2016. *http://www.chemchina.com/en/press/press/A604001web__1.htm.*

A.1.b. Yes, the U.S. Government should take into consideration the accumulative percentage of market control by Chinese SOEs. The Chinese Communist Party uses SOEs to pursue social, industrial, and foreign policy objectives. Therefore, SOE activities should be scrutinized to determine the reasons behind these investments.

Q.1.c. Can an over-reliance on China for U.S. domestic food supply qualify as a valid threat to U.S. food security or U.S. national security, and what is the difference between the two?

A.1.c. According to the United Nations Committee on World Food Security, food security is the condition in which all people have access to sufficient, safe, and nutritious food.[3] Meanwhile, the Heritage Foundation's *2015 Index of U.S. Military Strength* defined national security as anything that protects national interests, which encompasses economic, military, political, and other forms of power projection.[4] In general, excessive reliance on any one country for food products should be avoided. Current evidence does not suggest the United States is over-reliant on Chinese agriculture products, although some processed foods are sourced there. According to data from the office of the U.S. Trade Representative, top food imports from China in 2015 included processed fruit and vegetables ($1 billion), fruit and vegetable juices ($321 million), snack foods ($208 million), fresh vegetables ($178 million), and spices ($159 million).[5] Data from the U.S. Department of Agriculture show that in 2014 (the most recent available), China was the United States' third largest source of imported food, with $5.8 billion worth of food products imported that year.[6] Canada ($22 billion) and Mexico ($19.2 billion) are the largest sources of U.S. food imports.[7]

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM DENNIS C. SHEA

Q.1.a. You stated in your testimony that the Chinese government "is introducing policies that aim to replace established market leaders with [Chinese] firms." As you know, there is significant evidence that the Chinese government is stealing American intellectual property via cyber espionage and disseminating stolen technology to Chinese businesses.[1],[2]

Do you agree that the theft of American intellectual property by Chinese agents is a serious concern?

A.1.a. The Commission has been examining the cyber espionage threat China poses to the United States for many years. In 2015, for example, the Commission held a hearing on "Commercial Cyber Espionage and Barriers to Digital Trade in China." In the

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[3] United Nations Committee on World Food Security. *http://www.fao.org/cfs/cfs-home/about/en/*.

[4] Kim R. Holmes, "What is National Security?" in *2015 Index of U.S. Military Strength,* Heritage Foundation. *http://index.heritage.org/military/2015/important-essays-analysis/national-security/*.

[5] Office of the United States Trade Representative, "The People's Republic of China." *https://ustr.gov/countries-regions/china-mongolia-taiwan/peoples-republic-china.*

[6] U.S. Department of Agriculture, "Source Countries of U.S. Food Imports," March 30, 2015. *http://www.ers.usda.gov/data-products/us-food-imports.aspx.*

[7] U.S. Department of Agriculture, "Source Countries of U.S. Food Imports," March 30, 2015. *http://www.ers.usda.gov/data-products/us-food-imports.aspx.*

[1] DOJ Indictment.

[2] USS 337 Complaint.

corresponding chapter of the Commission's *2015 Annual Report to Congress,* the Commission stated that "China causes increasing harm to the U.S. economy and security through two deliberate policies targeting the United States: coordinated, government-backed theft of information from a wide variety of U.S.-based commercial enterprises and widespread restrictions on content, standards, and commercial opportunities for U.S. businesses."[3] Ongoing developments in Chinese cyber espionage are also assessed in the Commission's forthcoming *2016 Annual Report to Congress.* The Commission expects that the theft of American intellectual property by Chinese government-sponsored and supported agents will continue and will require vigilant monitoring.

Q.1.b. Do you think that the Administration's previous actions (*e.g.,* filing criminal charges against PLA operatives and engaging in formal negotiations to discourage hacking) have been effective in reducing illegal cyber espionage?

A.1.b. According to publicly available reporting, the effectiveness of the Administration's actions has been mixed. A June 2016 report released by the U.S. network security company FireEye indicates Chinese cyber espionage against U.S. companies has decreased in frequency since September 2015, when the United States and China signed a memorandum of understanding pledging that "neither country's government will conduct or knowingly support cyber-enabled theft of intellectual property."[4] However, several other factors could account for the decline of Chinese espionage, including increased sophistication of Chinese hackers, a decrease in public reporting of cyber crimes, or shortcomings of U.S. detection capabilities.[5]

- A report by the State Department's Overseas Security Advisory Council noted, "While media reporting has emphasized this alleged decrease in malicious activity, cases of Chinese espionage campaigns against the U.S. private sector are ongoing."[6]
- In an April 2016 interview with the *Financial Times,* Rob Knake, the former director of cyber security policy at the National Security Council, stated that while the days of widespread Chinese-sponsored espionage seem to be over, there's a consensus that "activity is still ongoing, but [it is now]

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[3] U.S.-China Economic and Security Review Commission, Chapter 1, Section 4, "Commercial Cyber Espionage and Barriers to Digital Trade in China," in *2015 Annual Report to Congress,* November 2015, 192.

[4] FireEye iSight Intelligence, "Red Line Drawn: China Recalculates Its Use of Cyber Espionage," June 2016, *https://www.fireeye.com/blog/threat-research/2016/06/red-line-drawn-china-espionage.html;* White House, *Fact Sheet: President Xi Jinping's State Visit to the United States,* September 25, 2015. *https://www.whitehouse.gov/the-press-office/2015/09/25/fact-sheet-president-xi-jinpings-state-visit-united-states.*

[5] U.S.-China Economic and Security Review Commission, private discussion with cyber security experts, June 9, 2016; U.S.-China Economic and Security Review Commission, *Hearing on Chinese Intelligence Services and Espionage Operations,* oral testimony of John Costello, June 9, 2016; U.S.-China Economic and Security Review Commission, *Hearing on Chinese Intelligence Services and Espionage Operations,* oral testimony of Mark Stokes, June 9, 2016; Jack Detsch, "Report: China Bolsters State Hacking Powers," *Christian Science Monitor,* February 4, 2016. *http://www.csmonitor.com/World/Passcode/2016/0204/Report-China-bolsters-state-hacking-powers.*

[6] Bill Gertz, "State Department Report Says Chinese Cyber Attacks 'Ongoing'," *Washington Free Beacon,* June 29, 2016. *http://freebeacon.com/national-security/state-department-report-says-chinese-cyber-attacks-ongoing/.*

narrower in scope and with better tradecraft" as hackers become more adept at covering their tracks.[7]

- In June 2016 testimony before the Commission, Mark Stokes, the executive director of the Project 2049 Institute, also highlighted the need to distinguish between China's "A team"—or their best computer and information security engineers—and the "B team," which is comprised of amateur hackers.[8] According to Mr. Stokes, "the A team is still just as active" in its efforts to exploit vulnerable U.S. computer systems.[9]

[7] David J. Lynch and Geoff Dyer, "Chinese Hacking of U.S. Companies Declines," *Financial Times,* April 13, 2016. *https://www.ft.com/content/d81e30de-00e4-11e6-99cb-83242733f755#axzz4BBcRuRz7.*

[8] U.S.-China Economic and Security Review Commission, *Hearing on Chinese Intelligence Services and Espionage Operations,* oral testimony of Mark Stokes, June 9, 2016.

[9] U.S.-China Economic and Security Review Commission, *Hearing on Chinese Intelligence Services and Espionage Operations,* oral testimony of Mark Stokes, June 9, 2016.