

MIZUHO CHINA MONTHLY

China's Economy	1
China's "Internet Plus": Facilitating New Industrial Development - From a FY2017 Study Commissioned to CAITEC of the Ministry of Commerce of the People's Republic of China -	
News from the China Advisory Department	24
The U.S.-China Trade War and Its Impact on the Financial Market	

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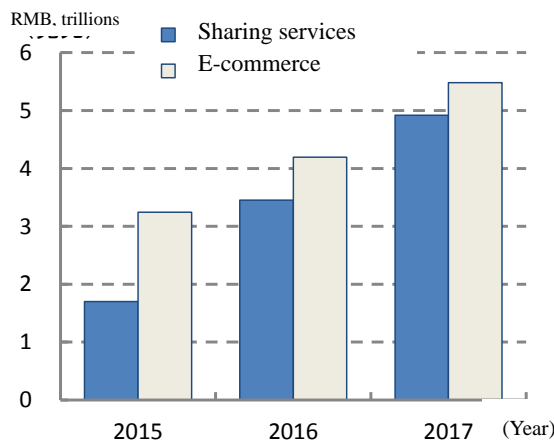
China Business Promotion Department
Advisory Department

Field	Specific examples
Daily life services	Store locators such as for restaurants, food delivery, etc.
Sharing services	Car-dispatching, ride-sharing, shared bicycles, etc.
Basic applications	Search engines, maps/navigation, news distribution
Public administration services	Education, social security, various administrative services (immigration control, transportation, tax services) etc.
Entertainment	SNS, live streaming, online videos, gaming, music streaming, online novels

Source: Created by the Mizuho Research Institute based on information from the Report

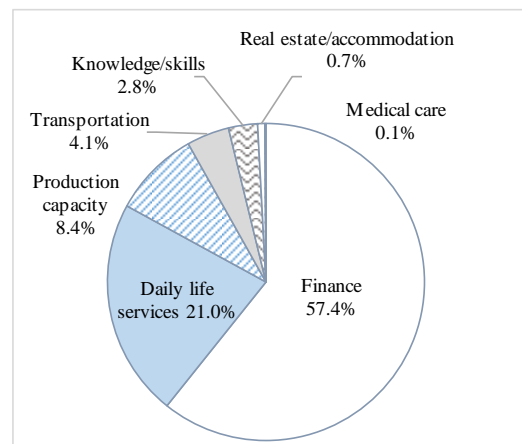
As mentioned above, these services have been becoming widespread mainly among young people as crucial aspects of daily life. Under such circumstances, these services have been rapidly growing over the past few years. Sharing services are a typical example. Their transaction value and the amount spent on them via EC stood at RMB 4.9 trillion and RMB 5.5 trillion as of 2017, growing 43% and 31% from the previous year, respectively (Fig. 2). Most sharing services are related to financial and daily life services (Fig. 3). However, the development of relevant laws and regulatory systems cannot keep up with the rapid growth of sharing services, and various negative effects have come to light, such as issues related to the protection of consumer rights. At present, standards have been created accordingly, as relevant authorities introduced regulations to address such issues or as each company or industry improves services and other issues. As a result, these services are gradually becoming mature, as a whole.

Fig. 2: Transaction value of sharing services and the amount spent via EC



Source: Created by the Mizuho Research Institute based on information from the State Information Center, Informatization Research Department, Internet Society of China, Sharing Economy Work Committee's *Development Report of China's Sharing Economy 2017* and the *Development Report of China's Sharing Economy 2018*, as well as from the National Bureau of Statistics of China and from CEIC Data

Fig. 3: Share of transaction value of sharing services by sector (2017)



Source: Created by the Mizuho Research Institute based on information from the State Information Center, Informatization Research Department, Internet Society of China, Sharing Economy Work Committee's *Development Report of China's Sharing Economy 2018*

3. Moves of major companies that led to the “Internet Plus” initiative

The development of “Internet Plus” is led by the three major Chinese IT companies of Baidu, Alibaba, and Tencent. These three companies offer diverse services and are collectively referred to as “BAT,” referring

to the first letter of each of their names. (They are sometimes referred to as “BATJ,” including Jingdong, which is growing as the fourth-largest IT company in China.) In addition, besides the BAT companies, there are many other companies that are growing in individual service sectors.

(1) Moves of Baidu, Alibaba, and Tencent

The corporate profiles of Baidu, Alibaba, and Tencent are summarized in Fig. 4. The main business line for each company at the time of founding is: search engine services (Baidu), EC (Alibaba), and SNS (Tencent). As internet restrictions imposed by Chinese authorities have limited the provision of similar services by major foreign enterprises, these companies have so far expanded their businesses.

Fig. 4: Corporate profiles of Baidu, Alibaba, and Tencent

	Baidu	Alibaba	Tencent
Establishment	2000	1999	1998
Address of head office	Beijing	Hangzhou	Shenzhen
Main founder	Li Yanhong	Jack Ma	Ma Huateng
Sales	RMB 84.8 billion	RMB 158.3 billion	RMB 238 billion
Total assets	RMB 251.7 billion	RMB 506.8 billion	RMB 554.7 billion
Main services (Random order)	<ul style="list-style-type: none"> • Portal sites (search engines, maps, etc.) • Daily life services • Entertainment • Financial services • Cloud services 	<ul style="list-style-type: none"> • EC • Logistics • Entertainment • Cloud services • Financial services 	<ul style="list-style-type: none"> • SNS • Entertainment (gaming, etc.) • Financial services • Portal sites • Cloud services

Note: Sales and total assets are as of FY2017.

Source: Created by the Mizuho Research Institute based on information from the Report and on information gained from the websites of each company, etc.

In addition to these undertakings, these companies now engage in a wider range of business, such as logistics, entertainment, finance, and cloud services, while embarking on new business such as running brick-and-mortar stores for promoting O2O (“online to offline”) business. Furthermore, they have formed strategic partnerships with IT companies outside their collective realm through investment, etc., and are now involved in daily life services (food delivery, travel services, etc.), transportation services (taxi dispatching, ride-sharing, shared bicycles, etc.), and other services. Such services are now being widely used by people in China in daily life.

a. Financial services

What is noteworthy among these services are financial services, which all three companies offer. These companies respectively provide major financial services, such as payments, loans, asset management, and credit rating (see Fig. 5). Even in a world where the pace of introduction of FinTech is accelerating, their moves are very advanced.

In particular, the widespread use of payment services is very common due to various reasons such as the dissemination of smartphones, insufficient provision of services by existing financial institutions, a reduced cost burden on stores thanks to the use of QR codes, and the still-existing circulation of counterfeit notes.

These services are rapidly making China a cashless society. Under such circumstances, it is now becoming common for people in China to go out without cash and to make all payments with a smartphone. In addition, payment data, etc., is utilized as big data to enhance credit assessment services and lending services (consumer loans and supply chain finance for micro and small enterprises, etc.). Meanwhile, in recent years, these three companies have been strengthening partnerships with existing financial institutions, such as by jointly establishing a laboratory for FinTech with a commercial bank, all to further develop and profit from the know-how that they have accumulated on their own and from new technologies, etc. (mentioned further below).

Fig. 5: Financial services offered by Baidu, Alibaba, and Tencent

	Baidu	Alibaba (Ant Financial)	Tencent
Payments	Baidu Wallet	Alipay	Tenpay WeChat Pay QQ Wallet
Lending	Baidu Umoney Baidu Loan	Ant Credit Antsdaq Taobao Crowdfunding Huabei, Jiebei	Weilidai
Asset management	Baidu Wealth Management	Yu'e Bao Zhao Cai Bao Cun Jin Bao	Licaitong
Credit rating	Baidu Enterprise Credit	Sesame Credit	Tencent Credit
Banking	Baixin Bank (established jointly by China CITIC Bank)	MYbank	WeBank
Insurance	Baian Insurance (permission yet to be issued)	ZhongAn Cathay Insurance	ZhongAn
Major partnerships with existing financial institutions	Agricultural Bank of China Sinolink Securities	China Construction Bank China Galaxy Securities China Everbright Bank	Bank of China China CITIC Bank China Investment Securities China International Capital Howbuy Futu Securities (Hong Kong)

Source: Created by the Mizuho Research Institute based on information from the Report and on information gained from the websites of each company, etc.

b. IoT and AI

The internet of things (IoT) and artificial intelligence (AI) should also be noted here—the development of which is active worldwide, in the same way as FinTech. The BAT companies are also putting effort into research & development for these technologies based on the big data that they have accumulated through the various services that they offer and through cloud services. At present, all three companies offer services related to IoT and AI platforms, etc. (see Fig. 6). They are competing with each other to provide solutions to cities, manufacturers, and households for, respectively, smart cities, smart industries, and smart homes.

Fig. 6: Cloud services and others that Baidu, Alibaba, and Tencent are offering or considering to offer

		Baidu	Alibaba	Tencent
Cloud platform		Baidu Cloud	Alibaba Cloud	Tencent Cloud
IoT	Platform	TianGong	Link	QQ IoT intelligent hardware open platform, WeChat hardware platform
	Main user fields	Urban management, logistics, manufacturing, automobiles, households	Households, commerce (retail, sharing services, etc.) urban management, manufacturing, agriculture	Households/daily life, automobiles, manufacturing, urban management
AI	Platform	Tianzhi, Apollo, DuerOS	ET Brain, Doctor you	Tencent Dingdang, Tencent Miying
	Main user fields	Automobiles, households	Manufacturing, cities, environment, medical care, aviation, finance	Households/daily life, gaming, SNS, medical care
	Field commissioned by the government	Automated driving	Cities	Medical images

Source: Created by the Mizuho Research Institute based on information from the Report and on information gained from the websites of each company, etc.

From here on, each company is expected to further advance technological development. In particular, as the first open innovation platform to be constructed under the government's *Next-generation Artificial Intelligence Development Plan*, which will be mentioned later, the government commissioned the field of "automated driving" to Baidu, that of "cities" to Alibaba, and that of "medical images" to Tencent. Thus, the BAT companies will play important roles in these respective fields. (iFlytek was commissioned for the field of "languages.")

c. Research & development trends

Each company puts effort into research & development in order to increase competitiveness in these cutting-edge fields (Fig. 7).

Fig. 7: R&D trends for Baidu, Alibaba, and Tencent

	Baidu	Alibaba	Tencent
Main research institutes, laboratories	Baidu Research <ul style="list-style-type: none"> Institute of Deep Learning Big Data Lab Silicon Valley Artificial Intelligence Lab Business Intelligence Lab Robotics and Auto-driving Lab Institute of Quantum Computing	Damo Academy <ul style="list-style-type: none"> Alibaba AI Labs iDST 	Tencent AI Lab Robotics X (tentative)
Major areas of research (Based on available data, such as media reports, random order)	<ul style="list-style-type: none"> Data science/mining Natural language processing Business intelligence Robotics, automated driving Computer vision Machine learning/deep learning Computational biology, bioinformatics 	<ul style="list-style-type: none"> Quantum computing Machine learning Basic algorithms Computer vision Natural language processing Human-computer interaction 	<ul style="list-style-type: none"> Computer vision Voice recognition Natural language processing Machine learning Robotics

	Baidu	Alibaba	Tencent
	<ul style="list-style-type: none"> • High-performance computing • Quantum computing 	<ul style="list-style-type: none"> • Chip technology • Sensor technology • Embedded systems 	
Amount of investment in product development	2015: RMB 10.18 billion 2016: RMB 10.15 billion 2017: RMB 12.93 billion RMB 10 billion will be invested in AI development each year from here onward.	2015: RMB 10.66 billion 2016: RMB 13.79 billion 2017: RMB 17.06 billion USD 15 billion will be invested over the next three years.	2015: RMB 9.04 billion 2016: RMB 11.85 billion 2017: RMB 17.46 billion

Source: Created by the Mizuho Research Institute based on information from the Report and on information gained from the websites of each company, etc.

Each company possesses research institutes and laboratories related to AI and other technologies and actively hires experts in the United States by establishing bases in Silicon Valley, etc. Each company's research activities cover basic to applied technologies related to AI, such as data mining, voice recognition, natural language processing, machine learning, and deep learning, while extending to a wide range of areas including quantum computing technologies and chip technologies, both of which play an important role in the development of AI, and sensor technologies and robotics for the use of IoT and robots, in addition to automated driving technologies, etc.

Based on these technologies, the total investment in product development of the BAT companies has been increasing year-by-year to RMB 29.9 billion in 2015, RMB 35.6 billion in 2016, and RMB 47.5 billion in 2017. However, compared to U.S.-based companies Amazon and Alphabet (the holdings company of Google, etc.), which have invested USD 22.6 billion (about RMB 147.8 billion) and USD 16.6 billion (about RMB 108.6 billion), respectively, the total investment of the BAT companies is still smaller. For that, Alibaba announced it would invest USD 15 billion in development for the next three years. In this way, the BAT companies will likely actively invest more going forward.

d. Partnerships with foreign companies

Furthermore, the BAT companies have been forming partnerships with foreign companies in recent years. They are partnering with companies of various business types, while their fields of collaboration are mainly those that they themselves focus on, such as cloud services, data use, FinTech, automated driving, and gaming (Fig. 8). For example, in the field of automated driving, Baidu is increasing the number of companies participating in the “Apollo” open platform. Tencent has built relations with more foreign companies in the field of gaming and entertainment, in which it excels.

Fig. 8: Partnerships formed with foreign companies by Baidu, Alibaba, and Tencent

Baidu	Alibaba	Tencent
FinTech <ul style="list-style-type: none"> • Robinhood • Paypal Data use <ul style="list-style-type: none"> • Hakuholdo Automated driving	Cloud services <ul style="list-style-type: none"> • Accenture • Ford Data use <ul style="list-style-type: none"> • Mattel • PepsiCo 	Cloud services <ul style="list-style-type: none"> • Cisco Systems • Oracle Automated driving/EVs <ul style="list-style-type: none"> • Tesla • HERE

Baidu	Alibaba	Tencent
<ul style="list-style-type: none"> • Microsoft • Intel • Bosch • Daimler • Ford • Delphi 	Tourism <ul style="list-style-type: none"> • Marriott International Gaming/entertainment <ul style="list-style-type: none"> • Hit-Point • Amblin Entertainment 	Gaming/entertainment <ul style="list-style-type: none"> • Pocket Gems • Glu Mobile • PUBG Corporation • Skydance Media • Sony Music Patent cross-licensing <ul style="list-style-type: none"> • Google

Source: Created by the Mizuho Research Institute based on information from the Report and on information gained from the websites of each company, etc.

(2) Other companies

In addition to the BAT companies, there are many other IT companies that offer services in the respective fields. Chapter 2 of the Report introduces companies representing the following service sectors of daily life, transportation, tourism, medical care, and education (Fig. 9).

Fig. 9: Representative IT companies in major service sectors

Service sector	Major companies
Daily life services	58.com/Ganji.com, Meituan-Dianping, Home King, Edaixi
Transportation	DiDi, AutoNavi
Tourism	Ctrip, Long, Mafengwo, Qyer
Medical care	Haodf.com, Chunyuyisheng.com, Wenwo.com
Education, etc.	VIP KID, 51Talk, Open.163.com

Source: Created by the Mizuho Research Institute based on information from the Report

For example, when it comes to daily life services, these companies have unique offerings, such as: information platforms for various services in relevant communities; information platforms related to food, etc., delivery services, restaurants, and leisure; and service platforms specializing in housekeeping, babysitting, and cleaning services. Furthermore, as for medical care and education, various aspects regarding daily life are covered, which has many issues such as long hospital reception wait times and the substantial time and effort required to take children to and from school and to lessons outside school, etc. For these issues, services using the internet to reduce such burdens are being offered. Apparently, the number of users of these services is increasing, due to consumers highly evaluating their convenience.

These companies are expanding their scales and are mutually complementing their services through mergers and other means. For example, companies listed in the “daily life services” sector in Fig. 9—58.com, Ganji.com, Meituan, and Dianping—were all once separate companies, but the former two companies and the latter two companies, respectively, merged in 2015. In addition, some companies, such as DiDi and AutoNavi, strengthened partnerships with the BAT companies by accepting investment and/or capital injections.

4. Major policies of the Chinese government

The Chinese government also supports the progress of “Internet Plus.” Major policies announced by the

central government are summarized in Fig. 10 below. In addition, local governments have also launched relevant policies in step with the moves of the central government. Chapter 3 of the Report mainly relays information on policies concerning EC, while a wide variety of policies have been issued, such as policies concerning areas where the application of internet technologies is aimed, along with policies concerning the promotion of the development of new technologies.

Fig. 10: Central government's major policies related to "Internet Plus" (random order)

Field	Major policies
"Internet Plus"	<ul style="list-style-type: none"> • Guiding Opinions of the State Council on Actively Promoting the "Internet Plus" Action (July 2015) • Guiding opinions on deepening the integrated development of the manufacturing industry and the internet (May 2016) • Guiding opinions on deepening the development of an "Internet Plus" advanced manufacturing industry for the internet for industrial purposes (November 2017) • Guiding opinions on promoting the development of "Internet Plus" smart energy (February 2016) • Guiding opinions on accelerating the promotion of "Internet Plus" administrative services (September 2016) • Guideline on the promotion of "Internet Plus" healthcare development (April 2018) • Implementation opinions concerning "Internet Plus" high-efficiency logistics (July 2016) • "Internet Plus Circulation" action plan (May 2015) • Implementation plan for developing smart transportation by carrying forward "Internet Plus" convenient and agile transportation (July 2016) and the three-year program for implementing "Internet Plus" green ecology (January 2016) • Three-year program for implementing "Internet Plus" artificial intelligence (May 2016) • Three-year program for implementing "Internet Plus" modern agriculture (November 2017)
EC	<ul style="list-style-type: none"> • Opinions on the vigorous development of EC to accelerate the development of a new driving force for the economy (May 2015) • Guiding opinions on promoting the healthy and rapid development of cross-border EC (June 2015) • Guidelines on promoting the acceleration of the development of rural EC (November 2015) • 13th Five-year Development Plan for E-commerce (December 2016)
FinTech	<ul style="list-style-type: none"> • Guiding opinions on promoting the healthy development of internet finance (July 2015) • 13th Five-year Plan for the Development of Information Technology in China's Financial Sector (June 2017)
IoT	<ul style="list-style-type: none"> • Guiding opinions on promoting the orderly and healthy development of IoT (February 2013) • an IoT book of the plan for information communication industry development (2016 - 2020) (December 2016)
AI	<ul style="list-style-type: none"> • Three-year implementation program for "Internet Plus" AI (May 2016, listed again) • 13th Five-year Plan on National Scientific and Technological Innovation (July 2016) • "Next-generation Artificial Intelligence Development Plan" (July 2017)
Others	<ul style="list-style-type: none"> • 13th Five-year Plan for National Informatization Planning (December 2016) • Information technology industry development plan (2016–2020) (December 2016) • Cyber Security Law of the People's Republic of China (implemented on June 1, 2017)

Source: Created by the Mizuho Research Institute based on information from the Report and on information gained from the relevant Chinese government ministries, etc.

For example, *Guidance on Actively Promoting Internet Plus Action Plan* was released in 2016 as a basic policy position for "Internet Plus," and the plan presents a means to integrate "Internet Plus" into all economic and social areas by 2025. The guidance cites the following 11 areas as "Key Internet Plus Actions": entrepreneurship and innovation; collaborative manufacturing; modern agriculture; smart energy; inclusive finance; public services; efficient logistics; EC; convenient transportation; green ecology; and artificial intelligence. Moreover, policies and plans related to these areas were announced in succession before and after the release of the guidance. Concerning services that have achieved growth ahead of other

services, such as EC and internet finance, basic policies for their development and control were released in 2015, earlier than the release of the guidance.

There are also plans related to the development and application of new technologies, such as IoT and AI. As for IoT, an IoT book of the plan for information communication industry development (2016 – 2020) sets a goal of promoting the application of IoT technology to: (1) industries (manufacturing, agriculture, and services [logistics, energy, environmental protection, medical care]); (2) consumption (automobiles, daily life, and healthcare); and (3) urban management (public facilities, communications networks, firefighting facilities, energy/water resource control, transportation, etc.), all to increase the scale of relevant industries to over RMB 1.5 trillion by 2020. For AI, the *Next Generation Artificial Intelligence Development Plan* aims to promote the application of AI technology to: (1) industries (manufacturing, agriculture, and services [logistics, finance, business, and daily life]); (2) public services (education, medical care, healthcare, and welfare services for the elderly); (3) social governance (administrative services, policy-making, judicial systems, urban management, transportation, and environmental protection); and (4) security and safety (anti-crime and anti-terrorism measures, food safety, and the monitoring of natural disasters, etc.), all to increase the scale of relevant industries to over RMB 11 trillion by 2030. In addition, concerning data, which is necessary for the utilization of IoT and AI, the *Cyber Security Law of the People's Republic of China* came into effect in June 2017, stipulating the basic principles of personal information protection, such as that data must be stored domestically and that a security assessment shall be conducted by relevant authorities when data is transferred overseas.

5. Proposals by CAITEC for Japanese companies based on examples in China

Chapter 4 of the Report provides tips for Japanese companies when conducting business related to China's "Internet Plus" initiative in Japan or in China. The major points are summarized in Fig. 11 below.

Fig. 11: Proposals by CAITEC for Japanese companies

	Proposals
Business in Japan	<ul style="list-style-type: none"> • Gathering competitive resources to create core competence • Raising the retention rate of users by meeting their experience needs • Building a large corporate foundation by creating new revenue models
Business in China	<ul style="list-style-type: none"> • Focusing on the trends of the Chinese government's policy for "Internet Plus" • Intensively investing in first-tier cities such as Beijing, Shanghai, and Guangzhou or urbanized coastal cities such as Hangzhou • Intensively investing in areas where Japan excels or where demand is growing relatively rapidly in China • Introducing more-open concepts and establishing platform systems based on win-win relations

Source: Created by the Mizuho Research Institute based on information from the Report

(1) Offering new services in Japan

Concerning the launch of new services in Japan, the Report first states that Japan is slower than China in

this regard and points out three issues as directions of measures to be taken in the future.

The first issue is to strengthen core competence. In China, the BAT companies respectively gain customer bases due to their strengths, such as search engine services, EC, and SNS/gaming. Based on the gained customer bases in these areas, these companies are combining and offering various platform services in an attempt to increase scale. In Japan, systematic and professional platforms that can integrate the providers of respective services have not been sufficiently developed. Under such circumstances, the Report points out that Japanese companies first need to strengthen and establish the areas where they excel, like the BAT companies have done, and to then build platforms centering on such areas.

The second is to raise the retention rate of users by meeting experience needs. CAITEC points out that, in Japan, service industries are matured and stable, and consumers have high levels of satisfaction for existing services related to daily life, and that this leads to insufficient motivation by consumers to use new services using internet technologies. Then, the Report proposes that companies should: place more emphasis on user experience as obtained through the use of new services, take action for changing needs in a speedy manner, and repeatedly make improvements, in order to increase the retention rate of users and disseminate new services.

Finally, the Report points out the need to actively build new revenue models. CAITEC states that the typical characteristics of Japanese companies, such as conservative corporate cultures, emphasis on precedents, and risk avoidance, hinder the creation of new revenue channels and models, which also leads to a relative delay in the dissemination of new services. For that reason, CAITEC proposes that companies need to use their own services and characteristics while actively seeking to establish new revenue models, such as advertising, application development, and value-added services, etc., which have already been realized by the BAT companies.

(2) Entry into the Chinese market

The Report lists four points regarding entry into the Chinese market. The first point is to follow the various policies announced by the Chinese government. As mentioned previously, the Chinese government has launched various policies and plans to achieve the healthy development of “Internet Plus,” clearly relaying development goals such as industrial scale and specific key areas. These promotion policies are translated into concrete actions in a phased manner or are reviewed according to changes in the situation, thus it is necessary to understand relevant policies in a timely manner.

The second is to intensively invest in large coastal cities. In major coastal cities, the internet penetration rate is relatively high, and business environments are favorable. In addition, the local governments of such cities focus on the development of “Internet Plus.” Therefore, such cities are important markets for the BAT companies as well. For Japanese companies, it will be easier to target coastal cities, where the income levels and lifestyles of people are similar to those of advanced countries.

The third is to intensively invest in areas where the strengths that Japanese companies have in Japan and the needs in China are linked. More specifically, the following three areas are pointed out: (1) the logistics industry (supermarkets integrated with the internet, online shopping that makes use of Japanese brands, logistics services industry, etc.); (2) the manufacturing industry (mainly home appliances and automobiles); and (3) the tourism industry (integrated platforms for the purchase of various tickets necessary for sightseeing in Japan, along with one-stop services related to various services such as transportation and accommodation). Then, the Report proposes that it is important to combine the characteristics of each region and key area and to select areas for investment.

The fourth is to introduce more-open concepts and to build win-win platforms. The BAT companies offer open platforms to EC tenants, application developers, and other third parties, and build ecosystems based on win-win relations. By doing this, they combine various values and have achieved growth. CAITEC points out that Japanese companies can refer to their experience. Meanwhile, other than building platforms on their own, participating in existing platforms as third-party players could also offer a route for entry into the Chinese market.

6. Conclusion

As mentioned above, new forms of services have been created one after another in China, thanks to “Internet Plus,” which has brought about great changes to Chinese society and to people’s lives in China. These services are led by emerging IT companies represented by the BAT companies, which are creating a vast ecosystem through mergers and partnerships. etc.

These companies are expected to invest a huge amount of money into research & development for the development and application of new technologies going forward, while many new start-up companies are being founded. The government basically promotes innovation for the dissemination and expansion of “Internet Plus,” while strengthening regulations on any problems caused by the emergence of new services. From here on, as the development of IoT, AI, etc., advances mainly in companies and at government research institutes, it is highly likely that the latest and most-advanced services will start to be disseminated from China to the rest of the world.

Amid such a situation, Japanese companies will need to follow the trends in China as precedents when considering business strategies for new areas in Japan. When conducting business in China, it is true that there are some obstacles such as restrictions on data storage and overseas transfer. Thus, Japanese companies need to carefully look at areas where they can demonstrate their strengths while taking into account policy trends, then seeking to cultivate Chinese markets through cooperation with Chinese companies, such as by offering hardware and by participating in platforms.

The U.S.-China Trade War and Its Impact on the Financial Market

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1. Introduction

Since the beginning of 2018, the administration of U.S. President Donald Trump has been stepping up its tough stance on China regarding trade. In 2017, the first year of the Trump administration, it was busy dealing with Obamacare and tax reforms, and major U.S. trade policies consisted only of withdrawal from the Trans-Pacific Partnership agreement and the renegotiation of the North American Free Trade Agreement (NAFTA). In 2018, the year of the mid-term elections, the Trump administration has been implementing long-awaited “America First” trade policies. In particular, regarding U.S.-China trade negotiations, some initially predicted that the issue of a U.S.-China trade conflict would not get serious. Despite such an optimistic view, however, the situation is taking on the aspect of a “trade war.”

Since February 2018, China has launched countermeasures against the U.S. trade sanctions on China. At the same time, China filed a request for consultation under the World Trade Organization dispute settlement framework. China has shown a compromising attitude by emphasizing the acceleration of opening-up policies, strengthening law enforcement against violations of intellectual property rights, and expanding imports from the United States. However, unfortunately, the two countries have failed to maintain friendly relations. The U.S. government implemented punitive tariffs on Chinese imports on July 6 as planned, while China then imposed retaliatory tariffs on U.S. products. Subsequently, on July 10, the United States published a list of Chinese products to be hit with additional tariffs, amounting to an additional \$200 billion. According to media reports in mid-July 2018, the tariffs will be implemented after August 30 after public hearings and after completing the public comment process. The U.S. pressure on China has not lessened, and a sense of tension remains in the U.S.-China trade negotiations. The situation requires caution.

This article will explore the future of the U.S.-China trade war and its impact on the financial markets based on the relationship between the trade policies of the Trump administration, which is persistently increasing pressure on China, and the “Made in China 2025” program.

2. Reasons behind the increasing U.S. pressure on China

When considering the future course of the U.S.-China trade war, it is necessary to understand the basic concept behind the Trump administration’s trade policy. A look at the statements of President Trump after taking office, of senior officials of the U.S. Trade Representative (USTR), and of others reveals that they apparently see trade as a zero-sum game and think that the United States is at a disadvantage because it is forced to buy imports from countries having a trade surplus with the United States, resulting in a decrease of U.S. jobs. In other words, the underlying idea of the Trump administration’s trade policy seems to be “trade surplus / deficit = corporate surplus / deficit” and “countries having trade surplus with the United States = countries unfairly abusing U.S. interests.”

Such an idea is also reflected in *Report on Foreign Exchange Policies of Major Trading Partners of the United*

States.ⁱ After President Trump took office, the United States added new criteria for adding a country to the Monitoring List of major trading partnersⁱⁱ (see Fig. 1), which is presented in the report and described as a trading partner that “accounts for a large and disproportionate share of the overall U.S. trade deficit,” apparently with China in mind. (China is the only country that was added to the list due to the criteria.)

Fig. 1: Monitoring list of major trading partners that merit close attention regarding their currency practices

	Trade surplus with the U.S.		Current account balance		Foreign exchange intervention	Listed countries
	Quarterly average (USD, billions)		Share of GDP (quarterly average, %)		Net purchase of foreign currencies Share of GDP (%)	
	Large and disproportionate	Over \$20 billion	Absolute amount (USD, Billions)	3% or more (%)	2% or more (%)	
China	✓	375	168	1.4	-0.6	v
Japan		69	197	4.0	0.0	v
Germany		64	299	8.1	-	v
Mexico		71	-18	-1.6	-0.2	
Italy		32	54	2.8	-	
South Korea		23	78	5.1	0.6	v
India		23	-39	-1.5	2.2	
France		15	-15	-0.6	-	
Switzerland		14	67	9.8	6.6	v
Taiwan		17	84	14.6	1.3	v
UK		-2	-107	-4.1	0.0	
Canada		18	-49	-3.0	0.0	
Brazil		-8	-9	-0.5	0.1	
Eurozone		133	440	3.5	0.0	

Source: U.S. Department of the Treasury

Note: The shaded parts suggest items that exceeded the criteria.

Trade deficits are the result of economic activities, and they cannot be resolved by trade policies—this is the general idea among modern economists. However, when trade policies are discussed under the Trump administration, this “general idea” seems not to be considered. According to U.S. trade theory, imports from China could decline due to tariffs, but the impact on U.S. companies engaging in economic activities in China or offering goods and/or services in China is not taken into account. The mercantilist idea of the Trump administration (trade = zero-sum game) is the source of trade pressure on China, but at the same time, it is a “double-edged sword,” coming back like a colossal boomerang to hit U.S. companies directly in the pocketbook.

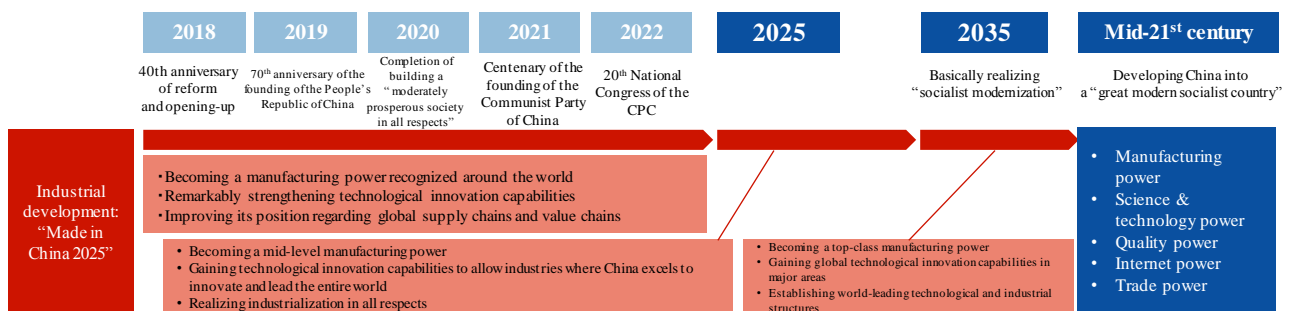
For the Trump administration, which sees a country having a trade surplus with the United States as an enemy, it is natural to step up pressure on China—which has the largest trade surplus with the United States. However, trade surplus is not the only reason for the United States to increase pressure on China.

“Made in China 2025,” which is an industrial policy advocated by China, also lurks in the background of the increasing pressure on China from the United States. This policy aims for supremacy in next-generation industries.

The “Made in China 2025” program is a roadmap for the development of the Chinese manufacturing industry (see

Fig. 2) and was unveiled by the Chinese government in May 2015, with the ultimate goal of making China the “world’s leading manufacturing power” by 2049, which will be the centenary of the founding of the People’s Republic of China. The program designates 10 key industries of development that the Chinese government will focus on (see Fig. 3) and pledges to mobilize all policy means such as financial and fiscal policies to support the development of these areas.

Fig. 2: “Made in China 2025” roadmap



Source: Report of the Chinese Academy of International Trade and Economic Cooperation of the Ministry of Commerce of the People's Republic of China

Fig. 3: 10 key industries designated in the “Made in China 2025”

- (1) Next-generation information communications technologies, such as 5G
- (2) Advanced digital control machine tools/robots
- (3) Aviation/space facilities
- (4) Ocean facilities/high-tech vessels
- (5) Rail transit facilities such as advanced railways
- (6) Energy-saving/new-energy vehicles
- (7) Electric power systems
- (8) Agricultural machines/facilities
- (9) New materials
- (10) Biopharmaceuticals/high-performance medical equipment

Source: Report of the Chinese Academy of International Trade and Economic Cooperation of the Ministry of Commerce of the People's Republic of China

“Made in China 2025” is aimed at vying with strategies launched by advanced countries one after another for upgrading the manufacturing sector (such as Industry 4.0 and New Robot Strategy), strengthening innovation and brand power (which China relatively lags in compared to other advanced countries),ⁱⁱⁱ and realizing the “Chinese dream” of making China a “world-leading manufacturing power” (i.e., an advanced industrial country).

The United States has been fiercely criticizing the “Made in China 2025” program, saying that China is trying to dominate the emerging high-tech industries that will drive future economic growth and that the program will hinder the economic growth of the United States and many other countries. The United States investigated Chinese tech company Huawei Technologies on suspicion of violating U.S. sanctions in relation to ZTE and also investigated Iran at the same timing as when the trade conflict intensified. Furthermore, additional tariffs that went into effect on July 6 are imposed mainly on goods related to the “Made in China 2025” program, including automobiles, semiconductors, medical equipment, and industrial machines. This suggests that U.S. trade negotiations with China focus on Chinese high-tech industries as emphasized in “Made in China 2025.”

At the same time as the imposition of additional tariffs on July 6, the Office of the United States Trade Representative (USTR) announced that it will accept applications for exemptions from the additional tariffs from U.S. companies that import Chinese products and others until October 9. However, in making its determination on each request, the USTR says that it may focus on whether a product concerned is related to the “Made in China 2025” program. The basis of U.S. trade policy with China could lie in trade deficits with China and its ulterior motive for supremacy in next-generation industries, as these two aspects are deeply intertwined with each other.

3. Future of the trade war

In the 1990s, the United States published sanctions lists against China under Section 301 of the *Trade Act* of 1974 and under the *Special 301 Report*. When such lists were published, the two countries repeatedly reached a settlement in about two months after the release in a way in which China made compromises. However, since 2018, China has shown strong opposition to U.S. trade restriction measures. When the United States released the sanctions list in June, China issued a statement that includes countermeasures five hours after the list was released. When the United States implemented tariffs on Chinese products on July 6, China immediately implemented retaliatory tariffs with the “same scale and intensity” on imports from the United States.

However, despite China’s strong opposition and imposition of retaliatory tariffs, the United States has not halted its offensive against China, and it is further intensifying its hardline stance against China by releasing, on July 10, a list of Chinese products that will be hit with newly imposed 10% tariffs amounting to \$200 billion. The latest move brought total Chinese imports subject to new tariffs to \$250 billion, which surpasses China’s imports from the United States (equivalent to \$150 billion). As a result, China cannot take any measure to impose retaliatory tariffs with the “same scale and intensity.” (See Fig. 4.)

Fig. 4: Top 5 importers of goods from the United States and China

U.S.	Importing country/area	Amount (USD millions)	Ratio	China	Importing country/area	Amount (USD, millions)	Ratio
1	China	505,597	21.58%	1	Eurozone	196,758	10.74%
2	Eurozone	343,447	14.66%	2	South Korea	177,562	9.69%
3	Canada	299,975	12.80%	3	Japan	165,773	9.05%
4	Mexico	314,045	13.41%	4	U.S.	154,933	8.46%
5	Japan	136,544	5.83%	5	Australia	92,808	5.07%

Source: International Monetary Fund

Under such circumstances, China is said to be preparing retaliatory measures against the United States, which will be comprehensive in nature by combining quantity and quality, according to the Ministry of Commerce of the People's Republic of China. Various countermeasures could be possible, such as limiting the release of Hollywood movies, suspending group tours to the United States, strengthening immunities at customs, boycotting U.S. products, and raising retaliatory tariff rates. Among these, this article will explore the “boycotting and selling of U.S. Treasuries” and the “devaluation of the yuan,” both of which are possible countermeasures to be taken in the

financial market.

Thanks to a trade surplus lasting many years, China holds the world’s largest amount of foreign reserves, worth over \$3 trillion. There are no financial instruments that have fluidity enough to manage China’s foreign reserves other than U.S. Treasuries. At present, China holds \$1.2 trillion in U.S. Treasuries, the largest held by any single country. (See Fig. 5 and Fig. 6.)

Fig. 5: China’s foreign reserves and the balance of

U.S. Treasury holdings

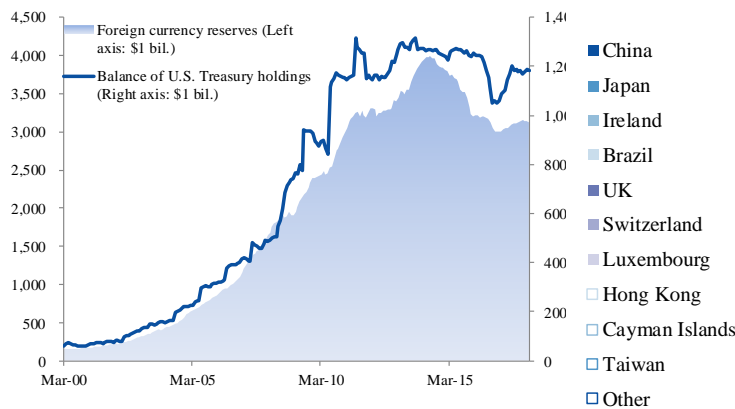
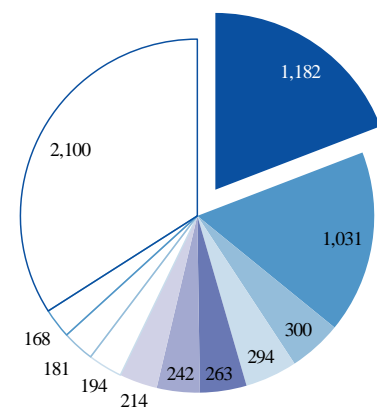


Fig. 6: Balance of U.S. Treasury holdings by country

(USD, billions)



Source: People’s Bank of China and the United States

Source: United States Department of the Treasury

Department of the Treasury

Last year, the United States decided on a tax reform including a \$1.5 trillion tax overhaul, while the Federal Reserve Bank completed asset purchases. Amid such a situation, if the “world’s largest buyer” begins to sell off U.S. Treasuries, it could lead to financial concerns for the United States. However, many market players believe that China will not be able to sell off U.S. Treasuries for the following reasons: (1) a price decline caused by the selling off of U.S. Treasuries will result in a loss in the value of U.S. Treasuries held by China; and (2) there are no other markets where assets worth \$3 trillion can be managed.

As for the devaluation of the yuan, some media outlets report that Chinese authorities are ready to allow yuan depreciation as a countermeasure in the trade war. However, since 2015, China has promoted financial market reform and opening-up, aiming to make the yuan a key global currency. When the yuan continued to weaken in mid-June, the Chinese government continued to take a stance to set the People’s Bank of China’s (PBOC) middle rate, which is announced every morning, at higher levels than market forecasts. In addition, the fact that relevant Chinese officials claim the stability of the yuan indicates that Chinese authorities will not allow excessive one-way yuan depreciation. For these reasons, China is less likely to devalue the yuan as a countermeasure against the United States.

While the entire picture of China’s comprehensive measures combining quantity and quality has not been revealed, the future of the U.S.-China trade issue remains unclear, with no clear roadmap for settlement in sight. How will the two countries settle the issue and through what processes? The situation will require caution.

4. Impact on the financial market

Following the series of events that have intensified the trade conflict, the financial market is becoming increasingly volatile.

In June, the SSE Composite Index continued to fluctuate within a narrow range at the low-3,000 level. However, after the U.S. government announced on June 15 that it would implement additional tariffs on Chinese products as a sanction against the Chinese violation of intellectual property rights and other reasons, the index dipped below 3,000 and declined to its lowest level since June 2016. It declined by over 20% from the highs recorded earlier this year, and the market is reportedly weakening. (See Fig. 7.)

Fig. 7: SSE Composite Index



Source: Bloomberg

As for the dollar-yuan exchange rate, the yuan depreciation accelerated due to the intensified trade conflict and the concerns over a slowdown of the Chinese economy following the lowering of reserve rates on June 24, etc. On July 4, the yuan weakened to a level higher than 6.72 per USD—the lowest level since August 2017. However, as compared in Fig. 8, the yuan was seen as lagging behind the USD at around that time, and it is reasonable to think that the recent levels show that the weak yuan has reached a level appropriate for the high-USD level. Some observers believe that Chinese authorities are allowing the depreciation of the yuan in order to support companies for which export competitiveness will decline due to U.S. tariff imposition. However, the yuan depreciation eased after the governor and deputy governor of the PBOC made comments about concerns over yuan depreciation on the same day, July 4.^{iv}

With no end to the U.S.-China trade war in sight, there is concern over increasing volatility in exchange rates. The volatility of USDJPY was 7.7% year to date, almost the same with the fluctuation range of USDJPY of 7.8%. It is now widely known that the CNY is no longer a currency for which fluctuations are limited under a managed float system.

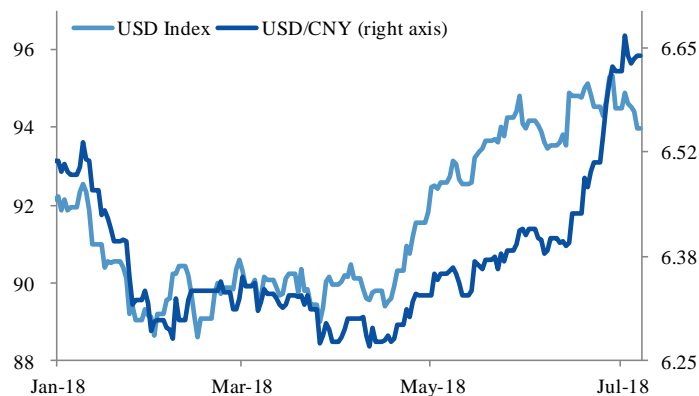
Concerning the tough trade pressure from the United States, China has made certain compromises, such as the acceleration of opening-up policies, planned expansion of imports from the United States, and strengthening of law

enforcement to protect intellectual property rights. However:

- China’s policy to increase imports aiming for reducing the trade surplus with the United States is causing concerns over a stronger USD and a weaker CNY; and
- The opening-up of the Chinese financial market to foreign businesses (increase in foreign fund inflow) is causing concerns over a weaker USD and a stronger CNY.

In this way, “China’s concessions” could cause concerns in both directions, and thus a further increase in volatility is expected.

Fig. 8: Changes in indices for the USD and CNY



Source: CFETS and Bloomberg

5. Conclusion

Since the Trump administration implemented sanctions under Section 301 of the *Trade Act* of 1974 in February this year, the situation of confrontation involving the United States and China has been continuing. Amid such a situation, Chinese President Xi Jinping committed to the further opening-up of China’s financial sector at the Boao Forum for Asia, while making certain compromises. However, the United States did not stop its offensive against China. There are three possible future scenarios: (1) the settlement of the trade conflict through negotiations resulting in an early resolution; (2) the gradual calming down of the situation through certain concessions by both sides; and (3) the intensification of the trade conflict by the imposition of retaliatory tariffs by both sides. As of mid-July 2018, when this article was written, there is no clear direction concerning the issue. According to media reports, some U.S. companies have already relocated their production bases to countries outside the United States, which indicates that, for companies, the “biased trade policies and the ulterior motive for supremacy in next-generation industries” of the U.S. government could be a major turning point in regard to corporate management. As mentioned in an article, it is clear that China is disadvantaged in this battle of imposing tariffs with the “same scale and intensity.” Amid such a situation, how China will promote dialogue with the United States continues to attract attention worldwide.

- ⁱ *Report on Foreign Exchange Policies of Major Trading Partners of the United States*: The report is also called the “Semiannual Report on Foreign Exchange Policies of Major Trading Partners of the United States” and refers to the *Semiannual Report on International Economic and Exchange Rate Policies* that the U.S. Department of the Treasury submits to Congress twice a year. The report includes analyses of economic management in other countries and is aimed at putting a brake on countries that manipulate exchange rates and guide their currencies to low levels.
- ⁱⁱ *Monitoring List*: This is a list of countries and regions that “merit close attention” due to their currency practices. The system allows the United States to give warning to the foreign exchange policies of its trading partners that do not necessitate immediate sanctions.
- ⁱⁱⁱ Deloitte Touche Tohmatsu Limited (*Global Manufacturing Competitiveness Index 2016*)
A full score is 100 points.

	U.S.	Germany	Japan	South Korea	China
Innovation policy	98.7	93.9	87.8	65.4	47.1
Cost competitiveness	39.3	37.2	38.1	59.5	96.3
Energy policy	68.9	66.0	62.3	50.1	40.3
Infrastructure	90.8	100.0	89.9	69.2	55.7
Legal and regulatory development	88.3	89.3	78.9	57.2	24.7

- ^{iv} PBOC Governor Yi Gang said that China will keep the yuan exchange rate basically stable at a reasonable and balanced level. PBOC Deputy Governor Pan Gongsheng said that he is confident in stabilizing the yuan within a reasonable range.

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