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China Dashboard Winter 2020 Update

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Rhodium Group (RHG) is an economic research firm that combines policy experience, quantitative economic tools and on-the-ground research to analyze disruptive global trends. Rhodium Group’s team conducts the research and economic analysis that is the basis for China Dashboard findings. For additional information on Rhodium Group and its services please contact clientservice@rhg.com.

With a problem-solving mandate, the Asia Society Policy Institute (ASPI) tackles major policy challenges confronting the Asia-Pacific in security, prosperity, sustainability, and the development of common norms and values for the region. ASPI’s team manages the Dashboard undertaking including funding, reviews, layout and presentation. For additional information on the Asia Society Policy Institute and its initiatives please contact PolicyInstitute@asiasociety.org.



Winter 2020 China Dashboard Net Assessment

Reform in the Time of Coronavirus

The coronavirus pandemic embroiling China and slowing large swaths of its economy, likely for a prolonged period, comes on the back of two sets of policy problems in China: the decline of economic reform and the U.S.-China trade war.

The pandemic relates to our China Dashboard policy appraisal in profound and complicated ways. Nevertheless, the virus is not a reason to put the reform discussion on hold, but rather a pressing cause for bolder leadership. Given that the economic system is already under great strain, aspects of reform that require near-term pain and sacrifice are off the table for now. The need for a *credible commitment* to a reform agenda, however, has never been greater. For firms, individuals, and international partners to remain engaged with China for the long term, they need better assurance that a reformed economic system lies ahead. Even before the virus hit, expectations were eroding in the face of evidence of economic weakness, credibility problems with other data, and indications of the radical slowing of reform and, in some cases, reforms being walked back.

A brave face and insistence that business as usual will be maintained do not match the reality of the economic standstill. Locking down the economy is, in part, a central effort to control the virus, but a radically franker acknowledgement of the collateral effects, for instance on the banking system, is essential. It is not overnight reform that is called for, but leadership and a rededication to policy adjustment that puts transparency and market functionality above doctrine and political pride.

Our ten gauges of policy movement in the most recent quarter collectively show a system not moving sufficiently in the direction of market efficiency to sustain medium- to long-term economic growth. By incentivizing officials to deny and cover up bad news rather than acknowledge and respond to it, China is making hard problems harder still to solve.

- This was true of swine flu, where local fiscal limits led officials to turn a blind eye rather than accept the loss of livestock.
- It is true of the financial system, where debt levels have grown unsustainable because the premise of stability and growth was too precious to relinquish.

- And now the coronavirus has spread worldwide, in part because frontline medical professionals were silenced rather than supported when they offered warnings.

While Beijing may have learned its virology lesson and has been transparent about infection rates since the World Health Organization was permitted inside the country to help in February, there has been a distortion of facts when dealing with the economic consequences of the outbreak. For instance, officials have been ordered to run government office air conditioners in winter, including over weekends, to make it appear that demand for electricity (and hence productive activity) is recovering.

Xi Jinping warned in 2013 that if efficiency-enhancing reforms were not implemented, China would find itself in a dead end. He was right. Yesterday's reform was deferred until today on the grounds that stability was too important and headwinds would abate in the future. Today has come, and it turns out now is not an option either. The price for implementing reform tomorrow will be much greater than it would have been in the past, and paying it will require acknowledging the mistake of not having started sooner. As painful as that seems, it will be much less expensive than standing still.

The data available through the third quarter of 2019 (those available for this edition) show limited economic reform progress, and much of the data needed to make a credible evaluation was delayed and not available even then – a problem exacerbated further by the virus. Three areas saw modest improvement over the previous quarter: **competition** policy, **state-owned enterprise** (SOE) reform, and **cross-border investment** opening. Policy in these areas remains far from sound, but after years of stalled movement modest improvements were positive signs. However, fully half of our ten policy dials show backtracking quarter-on-quarter. Systemic reform has been piecemeal at best. It has not been the central thrust of the government's economic policy efforts.

A Managed Trade Deal – Not a Reform Package

Is there reform light at the end of the dark tunnel of the past three years? As 2019 wound down, hopes rose that a U.S.-China agreement might improve the structural reform outlook. Donald Trump had sworn he would not settle for a weak deal and claimed to be content to raise tariffs on China even further if he did not get a breakthrough. A deal was indeed announced on January 15, 2020. Of seven substantive sections, three touch on aspects of the Chinese system that can be called structural: one each on intellectual property rights (IPR) protection

and technology transfer, and one on macroeconomic and exchange rate issues.

The reality is that the macro and exchange rate chapter of the agreement offers little more than a provision to consult on these issues in the future. On IPR and technology, the agreement offers promises to some industries and not others, and obliges a defendant to bring evidence that it is not infringing on another's patents. While vague, these pledges (like those that have come before) could be important if fulfilled.

Chapter 7 of the agreement covers evaluation and enforcement. But the baselines for gauging compliance will be kept largely secret because they were selectively based on a mishmash of U.S. and Chinese 2017 trade data to provide the most dramatic results. This calls the credibility of the enforcement chapter into great doubt: how can something not made public be taken as credible?

This leaves the remaining three chapters of the agreement which promise to improve U.S. exports of agricultural products, financial services, and everything else. This amounts to a managed trade arrangement to lift China's purchases of some U.S. goods and services by \$200 billion over two years. As such, it does not meaningfully improve prospects for Dashboard outcome indicators in most cases.

The structural impediments we have examined most in the Dashboard include the overexpansive role of **SOEs** that perform poorly relative to private firms, the distortive role of the **financial system** and **fiscal affairs** (preventing adjustment by continuously rolling over credit to unproductive firms and subsidizing political incentives), **competition** policy regimes that favor domestic interests, and many other concerns. The U.S.-China trade deal defers real attention to these issues to a future Phase Two. The deal promises changes to intellectual property rights protection and technology transfer conditions but is vague on implementation. Proposed dispute settlement arrangements are predicated on the threat of dissolving the whole deal more than a clear arithmetic for application.

The meaty commitments in the deal are found in chapters on trade in food and agriculture, financial services and "Expanding Trade" – that is, purchases of U.S. goods. The agreement outlines a managed trade program in which Beijing is to increase U.S. purchases from 2017 levels by \$77 billion in 2020 and \$123 billion in 2021 in four categories (manufacturing, agriculture, energy, and services). Stand-alone chapters on agriculture and financial services mostly serve to support this purchase

commitment, rather than promote systemic reform in China. The purchase commitments are the most robust and detailed, but they will not lift our expectations for trade reform indicators going forward because they only consider American interests and not overall liberalization. The agreement is to be measured by China's bilateral position with the United States, not its global trade position.

Making things even murkier, the 2017 baseline could be either U.S. export data, or Chinese import data, but we will not know because this will be kept secret. Stronger Chinese imports from the United States may displace imports from other countries, casting doubt on whether the arrangement complies with international trade rules. Can we at least be confident that the benefits for U.S. trade are assured? Maybe not: increased purchases of certain U.S. products could come at the expense of other U.S. products not subject to purchasing targets.

Is it reasonable to expect China's economy to generate enough growth in the next two years to absorb \$200 billion of additional exports from the United States? Pre-virus, the answer was *maybe*: if Beijing eschewed general policy reform, including in trade and finance, and instead primed the demand pump with more debt to stoke consumption, and if China diverted trade away from other trading partners to make Washington happy, and if prices for U.S. energy exports held up, and if we allow selective reference to U.S. or Chinese trade statistics to find the bigger numbers, then the \$200 billion increase goal *might* be achieved in two years. In light of this, it is ironic that one reason broader structural reform was not pursued *first* in a U.S.-China agreement is that it would have made it harder to achieve the special gains just for U.S. exporters that Trump wanted.

Make no mistake: a reforming China would grow slower (and thus consume less) for the next couple of years, but it would mean long-term sustainable growth. It would *not* take markets away from others to hand quotas to Americans.

What the Virus Means for Trade

Even with all these illiberal *ifs*, can China fulfill its Phase One import commitments given the coronavirus's economic impacts? It seems extremely unlikely. When the deal was signed, world markets were hoping to put the volatility and uncertainty from trade tensions behind them. At a minimum, a down-payment agreement would signal de-escalation and a more constructive atmosphere. Even non-U.S. firms were looking forward to a more predictable period.

The virus turned that expectation on its head. First quarter 2020 GDP growth will be negative quarter-on-quarter, and second quarter results will be weighted down as well. High-frequency data from China offer early warning signs of the fall to come. Population flows measured by passenger trips, one of the most important available indicators of the scale of the forthcoming slowdown, show an 82% drop year-over-year for the 25 days after Chinese New Year's eve in 2020. Even if bans on travel are lifted, production shutdowns will continue as long as workers, including migrants, stay home. Coal consumption, averaged for six major power plants, fell 42% compared with the 2019 post-holiday period. One of the biggest sectoral risks is the property sector – at once a pillar of China's economy and a hotbed for financial speculation and indebtedness. Daily property sales by floor space in February collapsed to practically zero, and developers who had been pre-selling property on leverage to finance construction are faced with cash flow problems and more defaults ahead.

Once the virus is tamed – *if* the virus is tamed – there may be a rebound in production of some products for which demand is pent up; but for many items consumption once foregone does not return. You do not have dinner twice tomorrow because you skip it today, and the same goes for vacations, movies, fuel to commute to work or take business trips, and many other activities. The crisis will greatly exacerbate nonperforming loan rates at virtually all commercial banks and financial insolvencies at firms. In our view, this financial washout from debt was bound to happen anyway, but the current morass amplifies the shock. Under our assumptions, China's imports both for domestic consumption and for reexport (since the global demand picture is depressed by the virus as well) soften rather than strengthen this year. Price effects (falling oil import costs for China) amplify this trade balance shock, making it much harder to satisfy U.S. expectations and trade diversion much more likely if Beijing attempts to do so.

Tariffs and Other Factors in the Escalation/De-escalation Equation

The specificity and scale of China's purchasing targets only reinforce the state's role in managing trade, rather than letting the market play a more decisive role. That is deeply troubling. And the same goes for the role of the U.S. government, which has been extraordinarily interventionist and distortionary in the past three years. Twitter overshadows the Federal Register. But at least interventionist governments can remove discretionary economic barriers as quickly as they were implemented. But is that what is happening?

Both sides have only partially reduced tariffs:

- Before the Phase One deal was concluded, the United States dropped a planned tariff increase for December 15.
- After signing the deal in mid-February, the United States followed through with announced halving of the 15% tariff rate on \$120 billion in Chinese goods but kept 25% tariffs on imports worth \$250 billion in place. In effect, the deal slightly reduces average U.S. tariff rates on Chinese imports from 21% to 19.3%, versus only 3% in January 2018, according to the [Peterson Institute](#).
- China's Ministry of Finance halved tariff rates for \$75 billion of U.S. goods imports including crude oil and soybeans upon signing of the deal in mid-February to facilitate increased purchases under Phase One commitments.
- Trade authorities in both countries have since created more opportunities for firms to apply for exemptions from tariffs, while Beijing has had to proactively cut tariffs in grappling with the virus's impacts.

While the public's attention is drawn to the tariff drama as a gauge for de-escalation because it offers simple percentage numbers, myriad other non-tariff barriers to economic engagement are not under discussion and in many cases are ratcheting up unilaterally. None of the new U.S. restrictions on inward investment or export controls have been removed. President Trump stated (via Twitter proclamation) that he would not permit overreaching national security claims to impede American business, and specifically squashed an attempt to block U.S. aircraft engine sales to China. But official exposés about nefarious Chinese commercial dealings as well as law enforcement and political campaigns against U.S. institutions and individuals deemed too China friendly continue to be a daily occurrence. Many business leaders privately observe that the risk of engagement is growing larger, not more manageable, since January 15.

Dialogues, Phase Two and Conclusions

Neither patterns to date nor the nature of the Phase One deal improves our Dashboard *Net Assessment* of prospects for future economic reform. The approach to policy adjustment detailed in depth in the ten sections of this appraisal reveals Chinese leadership looking for modest, piecemeal ways to make some progress, not bold moves. The virus emergency stymies even that minimal activism.

In the financial system, the emergency measures rolled out to avoid defaults are making the debt problems worse, and this is true in other areas. The U.S.-China deal does not significantly move the reform objective ahead.

There remains the hope that this government intervention is a necessary intermediate step – a down payment to address U.S. objectives while a more systematic plan to address structural matters is developed. That is the idea behind restarting the strategic economic dialogue (a macroeconomic dialogue to be held twice a year, and a trade dialogue) and setting expectations for a Phase Two negotiation on the deferred structural issues including subsidies and SOEs. Contradictory signals (from both sides) abound about the timing and scope of a Phase Two, as well as the role that the dialogues are to play in paving the way. President Trump has made conflicting statements, at times claiming that negotiations would begin following the Phase One signing ceremony, and at others indicating that they would not begin until after the next U.S. presidential election. In January, China’s lead negotiator Premier Liu He told state media that China was in no rush to start Phase Two negotiations.

The utility of formal bilateral dialogues should not be underestimated, if the goal really is to identify mutually beneficial actions that can be taken to supplement the deal landed so far. Multiple steps can signal upside potential for structural reform: among others, a halt to symbolic expulsions of journalists, release of individuals under political detention, joint actions to mitigate the virus emergency, and the identification of additional industries that can be opened to full commercial interaction now and not later. But the heavy economic policy lifting remains in Beijing’s court. To hold back forward movement as leverage for a Phase Two negotiation that might not start for a year – if ever – and will take years to conduct would be regrettable.

Competition

The Story So Far

Competition policy promotes rivalry among firms to maximize societal and economic welfare. In advanced economies, competition policy includes antitrust laws that protect consumer welfare from monopolistic behavior and other rules to prevent collusion, unfair practices that restrict competition and other abuses, and barriers to market entry and exit.

As China has reached a more advanced development stage, it has ratcheted up its competition policy objectives. Beijing passed a long-awaited antitrust law in 2008 after 13 years of discussion. The 2013 Third Plenum plan declared “developing an environment for fair competition” a priority. However, long-standing instincts favoring the interests of state-owned enterprises (SOEs) over consumers—and domestic firms over foreign ones—are still embedded in the Chinese system, with little regard for consumer welfare or fair competition.

- Since May 2013, the State Council has streamlined a wide range of administrative procedures related to business registration and taxation. New business registrations have risen steadily in recent years as a result, and in 2018, the World Bank recognized progress by substantially increasing its scoring of China’s “ease of doing business” compared with other countries. The State Council has promised to similarly reduce barriers to market exit, but progress has been much more limited.
- In June 2016, the State Council launched a “fair competition review mechanism” to clean up anticompetitive policies issued by government agencies at all levels. However, the mechanism did not clarify whether industrial policies should be considered anticompetitive, did not establish a transparent process to identify which current policies were anticompetitive, and did not prevent new anticompetitive policies from being implemented.
- Beijing has updated several competition-related laws since 2013 to reflect changing market conditions. In November 2017, China revised its 24-year-old Anti-Unfair Competition Law to cover emerging issues, such as commercial bribery and competition in new technologies like software and networks. In August 2018, the government also passed a new E-commerce Law to govern competition between internet companies. And it is in the process of revising patent and antitrust laws, ostensibly to strengthen legal protections for companies, although unequal enforcement between

state and private firms and between domestic and foreign firms remains a major concern.

- In March 2018, China’s National People’s Congress (NPC) approved a government restructuring plan that merged functions from various agencies responsible for enforcing competition policy. The new agency, named the State Administration for Market Regulation (SAMR), now oversees all aspects of China’s competition policy regime, including business registration, mergers and acquisitions (M&A) reviews, pricing policy, food security, consumer protection, and intellectual property protection. On paper, the SAMR’s creation reduced the influence of industrial policy regulators, but these bureaucratic changes have yet to drive any real improvement in China’s competition regime as measured in our indicators.

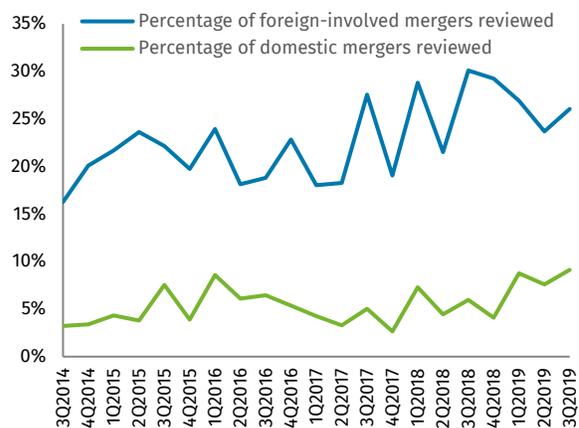
Methodology

Competition policy is an amalgam of law, economic analysis, and politics, and gauging outcomes is challenging. Our primary indicator looks for convergence in reviews of foreign versus domestic mergers conducted by the SAMR. Supplemental data look at the number of merger cases reviewed, disclosure of results of competition-related court cases, new business starts and closures (market entries and exits), and the ability of firms to obtain viable profits in healthy markets.

Quarterly Assessment and Outlook

Primary Indicator: Merger Reviews

Percentage



Source: State Administration for Market Regulation, Rhodium Group.

- Competition policy reform progressed this quarter but on net has not advanced. Beijing announced policies to protect foreign and private firms and their intellectual property (IP) with enforcement mechanisms, which appear serious.

- Foreign firms remain disproportionately targeted in merger reviews, but authorities are steadily increasing reviews of domestic firms. New business registration data were missing this quarter, suggesting it was disappointing.
- Policymakers have incorporated IP protection into metrics for evaluating officials' job performance and their legal responsibilities, as well as into regular U.S.-China trade talks. Beijing also started revising an 11-year-old Anti-monopoly Law with a focus on disciplining domestic firms.

This Quarter's Numbers

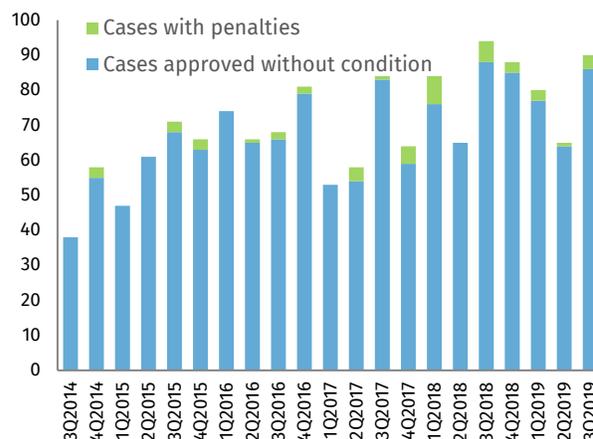
China stepped up merger reviews this quarter. In 3Q2019, the State Administration for Market Regulation (SAMR) reviewed 49 foreign-involved and 41 domestic mergers, an increase from 32 and 33, respectively, in 2Q2019. Proportionally, that means 26% of foreign-involved and 9% of domestic-only mergers were reviewed, compared with 24% and 8%, respectively, in 2Q2019, indicating lack of meaningful change. But the number of domestic mergers reviewed has steadily increased and in 3Q2019 reached the highest level on record in both absolute and percentage terms. However, foreign-related transactions remain disproportionately targeted for review.

Meanwhile, China's judicial system remains too opaque to protect market participant interests. Courts continue to publish more competition-related cases, but at a pace that lags the growth in disputes. In the third quarter, courts published 18,728 new cases, bringing the 2019 total to 32,741 cases – lower than the 46,078 in 2018. Courts may catch up on more old cases in the future, but overall the pace of publication is slow compared with the more than 40% growth of disputes a year since 2017 (see **Judicial System Transparency**).

Unfortunately, authorities did not release data needed to assess market conditions this quarter. SAMR has been silent on new company registration and dissolution figures for six months, the longest stretch of unreported data since 2012. It is not uncommon for China's statistical authorities to withhold data when the figures present a negative picture. On December 31, SAMR did announce that 21.8 million new entities (including companies and *getihu* – that is, small, sole proprietorship businesses) were registered in 2019, only 1.4% more than in 2018, a much slower growth than the 11.7% from 2017 to 2018.

Supplemental 1: Results of Merger Reviews

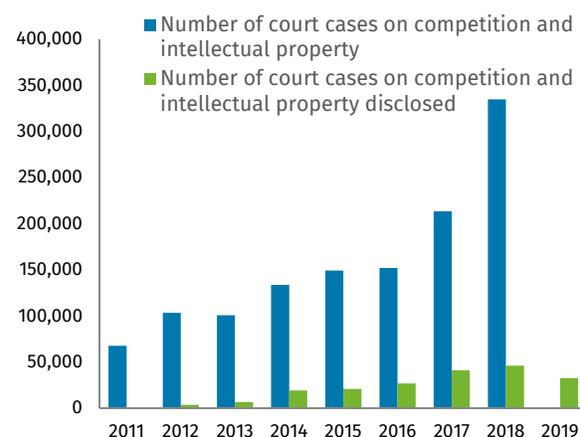
Number of cases



Source: State Administration for Market Regulation, Rhodium Group.

Supplemental 2: Judicial System Transparency

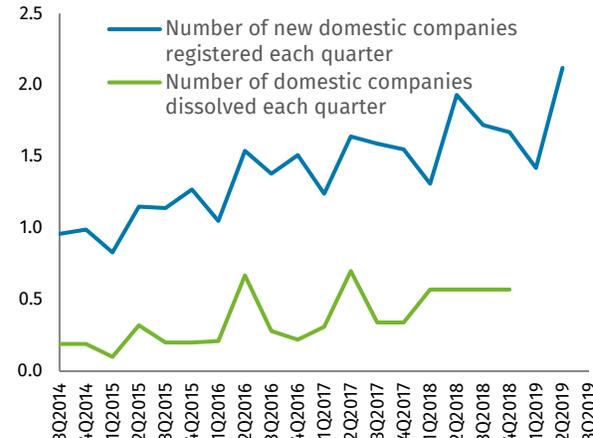
Number of court cases



Source: Judgements Online, Supreme Court.

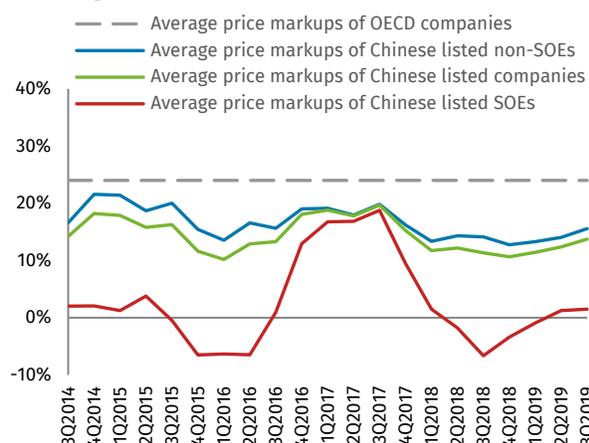
Supplemental 3: Market Entry and Exit

Millions



Source: State Administration for Market Regulation, Bloomberg, Rhodium Group.

Supplemental 4: Pricing Power Index
Percentage



Source: Bloomberg, Rhodium Group.

Policy Analysis

Beijing announced many encouraging policies in the period, all of which aimed at strengthening enforcement mechanisms. On November 24, the Party and the State Council jointly issued an “Opinion on Strengthening IP Protection.” On December 31, the State Council passed implementation measures for the new Foreign Investment Law, effective January 1, 2020. And on January 2, SAMR released a draft revision of China’s Anti-monopoly Law for public comments.

The November opinion on strengthening IP protection reflects heightened government prioritization of this issue. It sets out a timeline: by 2022 IP infringement should be contained, and by 2025 IP should be well protected in general. To arrive there, the opinion calls for increasing punishment for infringement and counterfeiting, improving the judicial system, and streamlining administrative processes. Importantly, it introduces a new mechanism to enforce the rules: IP protection will be included in local official performance evaluations.

The implementation measures of the new Foreign Investment Law (the *Measures*) also emphasize IP protection. They commit Beijing to provide equal protection to foreign investors and increase punishment for IP infringement. Furthermore, they explicitly prohibit governments from conducting forced technology transfers – a practice that China generally denies. With the *Measures*, foreign investors no longer need to file with the Ministry of Commerce to start businesses; they only need to register with SAMR, if not constrained by the still-fulsome negative list. At the same time, the *Measures* require all government bodies to publish regulatory documents related to foreign investments and fulfill their

commitments (e.g., tax benefits, favorable policies) to foreign investors. Officials violating these rules, informally restricting foreign investor capital flows, or treating foreign firms unfairly in the procurement process are to be held legally responsible and punished.

China is also holding itself to external commitments to strengthen IP protection. With the signing of the U.S.-China Phase 1 deal on January 15, China pledged to take certain actions with explicit timelines (e.g., increasing enforcement actions to stop counterfeiting goods within three months) and demonstrate improvement in IP protection via bilateral check-ins with the United States. Although these are not new responsibilities for China – Beijing has been assuring foreign partners that the spirit of these points would be kept for several decades now – the fresh commitments will raise the stakes for China’s credibility and relations with the United States if they are not clearly and straightforwardly met.

Meanwhile, China also started the process of revising its 11-year-old Anti-monopoly Law, with a focus on disciplining domestic firms. The revision would increase monetary penalties for some violations by 10 to 100 times. More importantly, firms failing to properly report mergers to regulators would now face fines of up to 10% of gross revenues in the previous year, up exponentially from a 0.5 million yuan (\$71,000) ceiling. For example, China Duty Free, which acquired Sunrise Duty Free in November 2018 and was fined only 0.3 million yuan (\$42,000) for not reporting the deal, could now be fined 1.5 billion yuan (\$200 million) based on 2017 revenue. The impact on domestic firms will be huge – our record shows that so far 16 domestic mergers have been fined for failure to notify authorities, compared with just seven foreign-involved mergers (see **Results of Merger Reviews**). The revision also adds guidance on analyzing the monopolistic positions of internet companies – arguably the most powerful companies in China today.

Cross-border Investment

The Story So Far

China is deeply engaged with the global economy through trade links, but it is far less integrated into cross-border capital flows. The country has now reached a development stage where financial account opening is critical for sustaining growth by increasing market discipline and efficiency in financial services, easing the transition to a new economic model, and supporting the competitiveness of Chinese companies. At the same time, policymakers are concerned that, if mismanaged, financial account opening could cause instability and compromise monetary policy independence. In its 2013 Third Plenum Decisions, China pledged to manage these challenges and move ahead with two-way financial market opening and capital account convertibility.

- Beijing has made some progress in inbound foreign direct investment (FDI) reform since 2013. China is moving from an approval-based system to a “negative list”-based system in which most foreign investments can proceed without government review except in restricted sectors. Beijing has reduced the scope of this negative list and partially lifted equity share restrictions (joint venture requirements) in financial services and automotive manufacturing.
- China has also broadened the channels for portfolio investment inflows. In addition to special programs (Qualified Foreign Institutional Investment, QFII, and RQFII, the same program denominated in RMB), investors are now able to use the Shanghai and Shenzhen to Hong Kong Stock Connect programs for equity investments and the Bond Connect program to access China’s domestic government bond market.
- In April 2019, several Chinese securities were included in the Bloomberg Barclays Global Aggregate Bond Index, the first major global bond index to add Chinese government and policy bank debt. This followed the inclusion of several Chinese large-cap stocks in the MSCI Emerging Markets Index in June 2018. More major equity and bond indices are likely to follow by adding Chinese debt and equities in the coming years.
- Meanwhile, China has backpedaled on capital account reforms. In 2014 and 2015, Beijing relaxed rules for outbound FDI, but regulators reversed course after outflows soared, pressuring the balance of payments and the exchange rate. Controls on other capital outflows were also tightened, including outbound

portfolio investment and currency conversion by households.

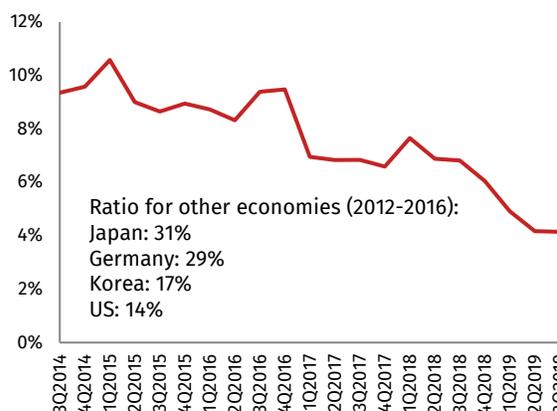
Methodology

To gauge cross-border investment progress, we sum the volume of capital flows into and out of China on a quarterly basis and divide by gross domestic product (GDP) in the same quarter. This primary indicator of China’s degree of financial integration tells us how China’s opening to external capital flows is progressing compared with overall economic growth. We supplement this assessment with other indicators of China’s integration into global financial markets: the balance of cross-border capital flows by category plus net errors and omissions, the breakdown of inflows and outflows by type, the buying and selling of foreign exchange reserves by China’s central bank, the role of foreign buyers in total Chinese mergers and acquisitions, and the share of the Chinese currency in global payments.

Quarterly Assessment and Outlook

Primary Indicator: External Financial Liberalization

Gross sum of cross-border investment flows under China’s financial account (excluding reserves) as a share of GDP, year to date, percent



Source State Administration of Foreign Exchange. National Bureau of Statistics.

- We slightly upgrade our assessment due to stronger portfolio inflows over the past two quarters, but overall capital flows remain far too small for an economy of China’s size.
- Capital outflows remain persistent. Foreign direct investment (FDI) inflows were seasonally low, causing the FDI balance to return to a deficit after more than two years. Foreign investors accounted for a bigger share of domestic mergers and acquisitions as overall deal flow cooled.

- Policy measures continue to facilitate inflows into China’s equity and bond markets. FDI inflows should pick up following the planned 2020 elimination of foreign equity caps for the insurance, brokerage, and asset management sectors.

This Quarter’s Numbers

Overall, China remains generally closed to capital inflows and outflows relative to more developed economies and has become relatively less open since the 2013 Third Plenum. Compared to the United States, with gross cross-border capital flows equal to 14% of GDP – or Germany (29%) and Japan (31%) – China only sees flows representing 4.15% of GDP (see **External Financial Liberalization**). Both inflows and outflows declined in 3Q2019 relative to 2Q2019 and in year-on-year terms, reflecting some seasonality, as FDI flows are usually weaker in the third quarter of the year.

However, the decline in China’s proportion of flows slowed for the first time in a year. Capital outflows are still sizeable and indicate persistent diversification from China’s large pools of household and corporate savings into foreign assets. This trend explains the large volume of outflows categorized as “errors and omissions” over the past three years and will continue despite capital controls. Outflows under the more market-sensitive “other investment” account also increased in 3Q2019, producing a deficit of \$38.9 billion during the quarter, adding on to \$39.4 billion in errors and omissions-related outflows (see **Net Capital Flows**).

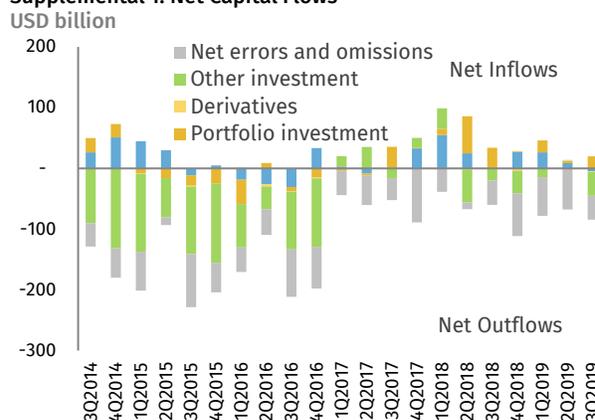
It is less certain whether potential sources of inflows *can* offset these persistent outflows. Foreign portfolio inflows offered a positive sign with a net surplus of \$20.0 billion in 3Q2019 as foreign investors followed major bond and equity indices and increased investments in China’s onshore financial markets, usually through the Hong Kong-based Bond Connect and Stock Connect programs.

FDI flows returned to deficit for the first time since 2Q2017, falling to \$5.1 billion in 3Q2019 (see **Breakdown of Cross-Border Financial Flows**). Third-quarter FDI inflows are typically seasonally low, but it is also possible that uncertainty related to the U.S.-China trade conflict depressed inbound transactions. Despite weaker FDI inflows, foreign buyers accounted for a larger proportion of acquisitions of Chinese companies in 3Q2019 (16%) than in 2Q2019 (13%) (see **Foreign Appetite and Market Access**). This increase, however, was not attributable to a rise in actual foreign mergers and acquisitions (M&As), but a cooldown in overall deal flow in 2019 amid policy uncertainty and the growing perception that China’s tech sector is overheated. M&As in China have fallen by 23%

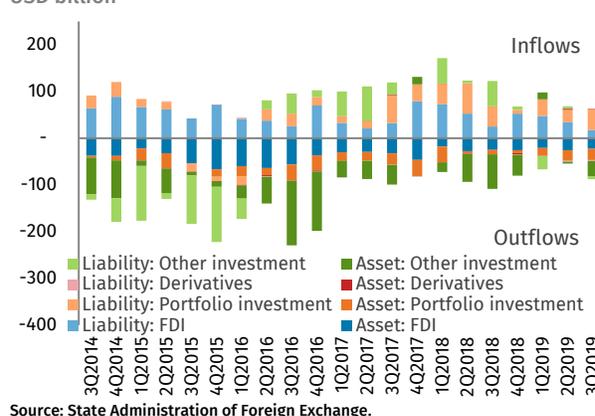
year-on-year (yoy) through the first nine months of 2019, and deals with all Chinese buyers have fallen 26% yoy, while foreign deals are relatively stable.

The central bank continued to intervene to sell foreign exchange reserves and defend the currency in 3Q2019 to the tune of \$16 billion, according to balance of payments data (see **FX Reserves**). Nonetheless, intervention has slowed over time, particularly since the heavier capital outflows seen in 2015 and 2016. International use of the currency remains limited, with our indicator of **Currency Internationalization** barely ticking up to 1.99% of global transactions, showing no significant movement over the past three years.

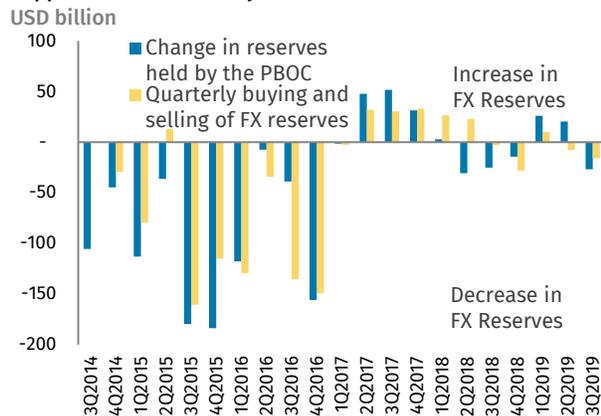
Supplemental 1: Net Capital Flows



Supplemental 2: Breakdown of Cross-Border Financial Flows



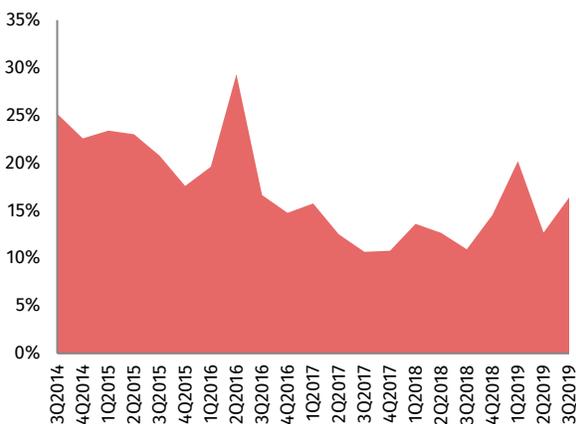
Supplemental 3: Currency Intervention



Source: State Administration of Foreign Exchange, Rhodium Group.

Supplemental 4: Foreign Appetite and Market Access

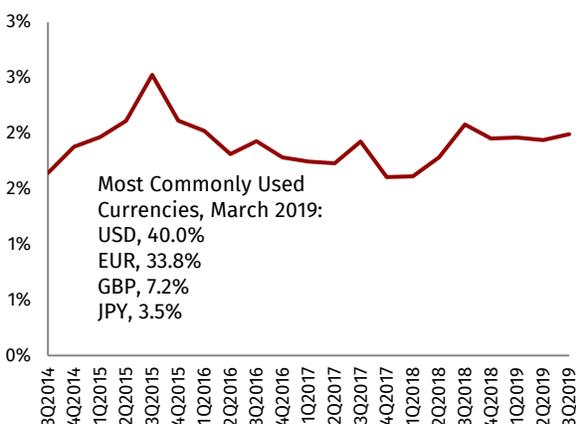
Share of deals with foreign buyers in total number of acquisitions with Chinese target, percentage



Source: Bloomberg. Announced deals tabulated by date of announcement and include all completed, proposed, and withdrawn deals.

Supplemental 5: Globalization of China's Currency

Chinese yuan (RMB) usage in global transactions, percent



Source: SWIFT.

Policy Analysis

The key question in assessing cross-border investment reform is how rapidly and credibly Chinese authorities can commit to greater openness to capital flows in both directions. So far, reforms have advanced in the direction of permitting more inflows gradually, particularly in new areas of China's financial system, but progress toward liberalization of outbound flows remains limited.

Over the past six months, Beijing continued to implement previous promises aimed at improving market access for foreign investment into China. The State Council released "Amendments to Regulations in the Finance Sector" on October 15, paving the way for implementing announced liberalization in the banking and insurance sectors. One week later, the State Administration of Foreign Exchange issued a circular to further promote and facilitate cross-border trade and investment, including measures to relax some restrictions on additional equity investment by foreign-invested enterprises (FIEs) within China. Finally, on January 1, 2020, China's new FDI law officially went into effect. A new implementation document was released, which provides more detail but does not spell out how key provisions, such as improved intellectual property rights (IPR) protection, are going to be enforced.

Some progress has been made in opening the automotive industry. An October State Council Regular Meeting confirmed that a new regulatory point system for electric vehicle (EV) manufacturing applies equally to domestic and foreign players. The lifting of equity cap restrictions in EV manufacturing in 2018 has already led to several new investments, including by Tesla). Looking forward, restrictions for commercial vehicles and passenger cars are to be removed in 2020 and 2022, respectively, potentially setting up the industry to receive a wave of FDI in the next few years, even though the automotive market is shrinking and the short-term outlook for China's auto industry is fraught due to messy implementation of emissions standards.

The Phase 1 trade deal between the United States and China is expected to promote inbound direct investment into China's financial sector, provided it succeeds in reducing political uncertainty in the bilateral relationship. China had already pledged to eliminate equity caps on foreign investment in several sectors, including insurance, fund management, and securities. The Phase 1 deal accelerated that opening for securities firms to April 1, 2020, while foreign equity ownership limitations on futures companies were already eliminated as of January 1, 2020. The test of these opening measures is really the size of the flows that ensue; in the past, Beijing has often used licensing requirements and application delays to limit

foreign competition even in nominally open sectors. But with this opening captured in the Phase 1 deal, the incentive to encourage additional foreign inbound investment to balance persistent outflows is now stronger.

One surprising aspect of the deal was a pledge to allow foreign firms to acquire asset management company licenses in the distressed debt industry, enabling them to buy nonperforming assets directly from banks at the provincial level. While no national licenses were granted, limiting the potential opportunity, it is likely that foreign investment in China's distressed debt market will expand given China's eagerness to find alternative buyers for bad debt and foreign investors' interest in a rapidly growing segment of China's financial system.

Another positive sign for reform is China's encouragement of portfolio inflows, particularly to the government and policy bank bond markets. Gross portfolio inflows averaged only \$50 billion per year from 2014 to 2016 and since then have increased to an annualized pace of \$142 billion per year. Chinese securities are expected to be weighted more heavily in global bond and equity indices in the coming years. However, the volume of portfolio inflows is not yet game changing for the stability of China's balance of payments position or for cross-border investment reform. Foreign investors may acquire greater proportions of bonds in China's government bond market, but overall investments will be limited as long as concerns about capital controls and currency risks (without appropriate hedging instruments) remain. China's capital markets are still opening far too slowly, at a time when the window for more aggressive foreign investment in the Chinese economy overall may also be closing, given uncertainties about future potential growth arising from delays in basic reforms.

Environment

The Story So Far

China's rapid economic rise has come at a heavy environmental cost, and its population is increasingly demanding an "ecological civilization" that addresses health-threatening air pollution, heavily polluted rivers and groundwater, and contaminated land. Studies estimate premature deaths from air pollution at 1 to 2 million per year, while the World Bank puts the overall cost of China's water pollution crisis at 2.3% of GDP. Policymakers are aware of these threats: the 2013 Third Plenum set environmental reform and sustainable development as some of the government's main responsibilities. Aided by structural transition away from polluting heavy industries, initial reform efforts are making a difference. Yet much more is required to put a sustainable future within reach, let alone to raise China's air and water quality to international standards.

- In 2013, officials released the first "Air Pollution Prevention" plan, requiring major Chinese regions to meet air pollution reduction targets within four years. Beijing was required to reduce air pollution by 33%, prompting it to shutter coal-fired power stations and curtail coal-burning heaters. A 2018 "Blue Sky" action plan built on the original 2013 plan by setting out further reduction targets of at least 18% for large cities and regions that lagged 2013 goals.
- Premier Li Keqiang announced a "war on pollution" in 2014, outlining plans to reduce particulate air pollution, cut production in overcapacity industries like steel and aluminum, shift away from coal power, and develop renewable energy and resources. While previous policy efforts suffered from a lack of concrete action, a revised Environmental Pollution Law reinforced the war on pollution by increasing penalties for polluters and integrating environmental performance into local officials' performance and promotion metrics.
- The winter of 2017–2018 featured an aggressive campaign against air pollution, including a strict coal-heating ban in northern cities. However, natural gas supply shortages and preemptive coal furnace removals prompted a heating crisis in some regions and forced officials to allow some flexibility at the local level. January 2018 revisions to the tax code also implemented sliding pollution tax rates; increased penalties; and initiated new rewards for firms that cut air, water, noise, and solid waste pollution. Importantly, the law put local governments at the forefront of enforcement, enticing them with 100% of pollution tax revenue.

- The State Council created a new Ministry of Ecology and Environment (MEE) in March 2018, consolidating scattered pollution enforcement and environmental powers from seven agencies. The previous Ministry of Environmental Protection had been sharply criticized even by domestic observers for feeble policy and perceived collusion with provincial interests. The MEE was meant to streamline governance and invigorate enforcement and local inspections.

Methodology

For the air pollution index, a range of factors drives seasonal concentrations of PM 2.5; one of the largest is the domestic use of coal for heating and cooking. We source monthly average PM 2.5 data from the China National Environmental Monitoring Center (CNEMC) for 74 Chinese cities. From these data, we remove some of these seasonal effects using a decomposition analysis. We then average the data across the 74 cities to produce our index. Previously, we utilized daily U.S. State Department air quality data from five environmental monitoring stations at U.S. consulates in China. Due to both the retirement of the U.S. State Department's air quality feeds and increased reliability of China's own air quality data, we implemented a switch to CNEMC data for our analysis starting in 3Q2019.

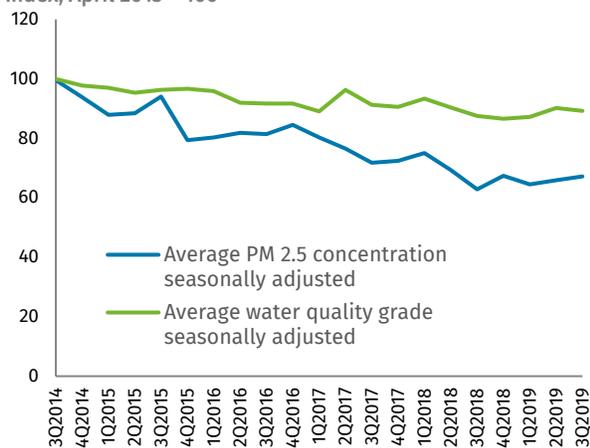
For the water quality index, we use data from the Ministry of Environment and Ecology (MEE). Specifically, we track the average water quality for the Yangtze, Yellow, Pearl, Songhua, Huai, Hai, Liao, and Zhejiang-Fujian river basins. The average water quality from these basins is aggregated into a national indicator. The MEE publishes water quality data on a monthly basis derived from several hundred monitoring stations across the country in key watersheds. Based on 21 indicators, including total nitrogen, pH, dissolved oxygen, heavy metals, chemical oxygen demand, and others (all based on Surface Water Environmental Quality Standard: GB3838-22), these surface water bodies are put into categories ranging from I (excellent, drinking quality) to V+ (high pollution, not suitable for any use). By tracking the changes in these categories over time, our water quality index can provide an idea of the overall health of Chinese surface water supplies. As seasonal effects can change water quality, we seasonally adjust this index as well. In January 2017, the Ministry of Environmental Protection (MEP, now MEE) started issuing weekly quality reports. We rely on these data for December 2016 through June 2018.

We rebase the air quality data to November 2014 as the benchmark to track quarter-on-quarter changes. Water pollution data only go back to October 2012. We also

adjusted the World Health Organization standards to provide a comparable context.

Quarterly Assessment and Outlook

Primary Indicator: Water and Air Quality Trends Index, April 2013 = 100



Source: Ministry of Ecology and Environment, US Department of State, Rhodium Group.

- We slightly downgrade our assessment to below neutral as most indicators showed environmental conditions in China deteriorated this quarter.
- Air and water quality worsened, even though economic activity growth slowed to decade lows.
- China moved to boost nuclear power generation but simultaneously increased coal-fired power plant construction (both domestically and abroad), undermining its emission reduction goals.

This Quarter's Numbers

Note: Due to a disruption in data availability from U.S. State Department Air Quality Monitoring (AQM) stations in China, starting in 3Q2019 we are utilizing data from the China National Environmental Monitoring Center (CNEMC). Our new dataset provides readings for 74 cities across China, up from five AQM stations utilized previously. The use of new data also requires us to rebase our pollution indicators from April 2013 to November 2014.

China's air and water pollution got slightly worse in 3Q2019, even though slower economic growth typically reduces high-polluting industrial activities and overall energy demand. Our **air quality index** modestly decreased, representing a small increase in air pollution. Pollution levels increased by at least 1 microgram per cubic meter of air in 40 out of 74 localities we track, including more than half the sampled cities in strong coastal provinces like

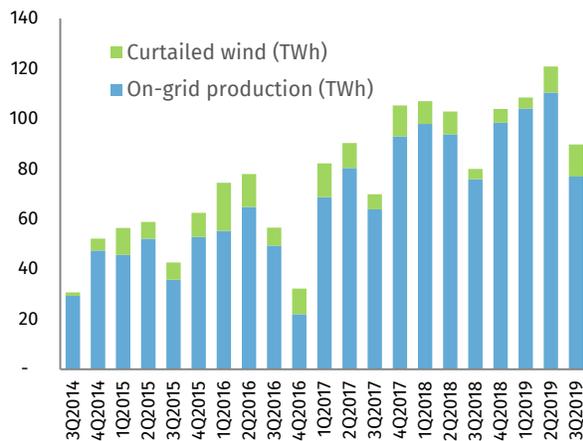
Zhejiang, Jiangsu, and Guangdong, where economic activity is likely less impacted by the aggregate slowdown. This indicator may slightly understate pollution in 3Q2019 due to several outliers; for example, Xingtai in Hebei province recorded a 13-point drop in its monthly PM 2.5 measure from 2Q2019 to 3Q2019, which makes national average pollution levels appear lower.

Water quality declined in three of the eight river systems that we track, with the Huang river system seeing the biggest drop (5% year-on-year). While authorities recently announced several measures to improve water quality in the Yangtze river system, our **water quality index** did not show improvement there in 3Q2019.

New energy vehicles (NEVs) are crucial to China's long-term pollution and environmental plans, but NEV sales declined sharply in 3Q2019, falling nearly 45% year-on-year (see **Sales of New Energy Vehicles**). This marks only the second quarter since 2013 that NEV sales have contracted, this time the result of canceled government subsidies for NEVs aimed at consolidating the industry. If policies prove too blunt, NEV manufacturers could face poorer conditions that result in missed targets for NEV sales. Policymakers must balance policies that support industry growth to meet ambitious NEV adoption goals (25% of all auto sales by 2025) with ensuring the industry is competitive enough to survive in the long term.

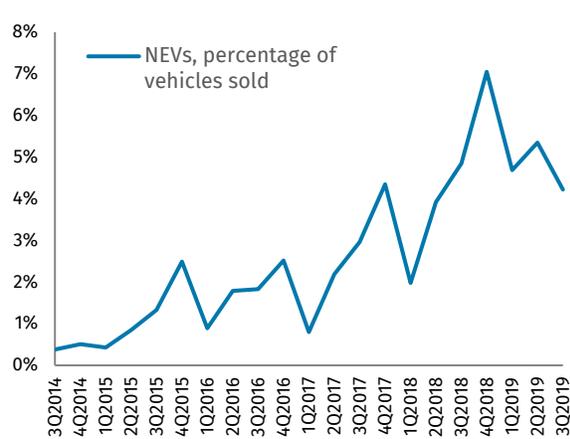
China is utilizing more renewable energy but is not doing so efficiently. The proportion of **spilled wind** –the amount of wind electricity that is wasted because it cannot be transmitted to the grid – increased to 14% of wind power generated. This marks the highest quarterly value since 2017 and is likely a consequence of China's increased wind energy capacity under a major push for renewable energy. At the same time, tighter economic conditions have dampened electricity demand. The resulting mismatch requires more wind farms to curtail generation to avoid overwhelming the grid, suggesting that regulators must improve grid management and interconnection policies. Even though wind and other non-fossil electricity generation moderately increased in 3Q2019, on a seasonally adjusted basis, energy production from fossil fuels rose even more (see **Non-Fossil Generation**). Although China's renewable production capacity continues to increase, this shows how renewables supplement, rather than replace, coal and other thermal power sources.

Supplemental 1: Wind Energy Curtailment
Terawatt hours (TWh)



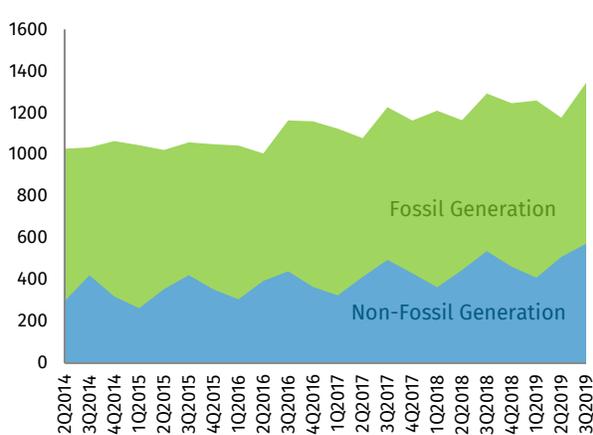
Source: China Electricity Council, Rhodium Group.

Supplemental 2: Sale of New Energy Vehicles
Percent



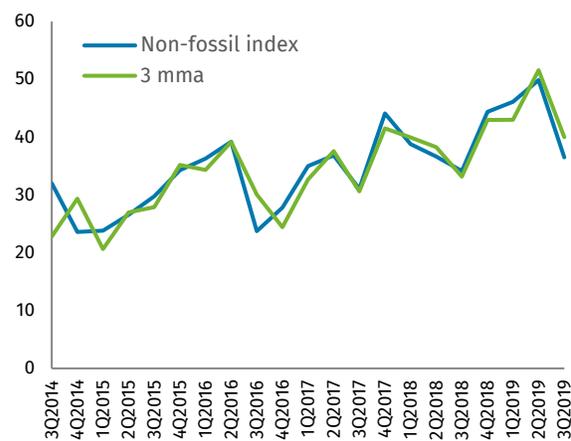
Source: China Association of Automobile Manufacturers, Rhodium Group.

Supplemental 3: Overall Electricity Generation
Billion Kilowatt-Hours



Source: National Bureau of Statistics, China Electricity Council, Rhodium Group.

Supplemental 4: Non-Fossil Electricity Generation
Index



Source: National Bureau of Statistics, China Electricity Council, Rhodium Group.

Policy Analysis

Policy efforts this quarter continued to focus on expanding China’s alternative energy production capacity. On July 25, the National Energy Administration (NEA) announced approval of the first new nuclear power plant construction applications in three years. (China’s nuclear industry has been under a de facto ban on new plant construction since the 2011 Fukushima Daichi disaster in Japan.) Together, China’s new nuclear plants will make it the world’s second-largest nuclear power producer by 2022, reducing its emissions on the margins by increasing the non-coal power supply. However, nuclear is unlikely to be a panacea. First, new coal capacity is also expanding (see below), meaning new nuclear plants are not substituting but rather supplementing coal. Second, the rapid decline in the price of renewable energy sources like solar and wind makes nuclear less cost-competitive.

Even as non-fossil energy generation is expanding, fossil generation is not being phased out as officials have simultaneously ramped up coal consumption and new coal plant approvals. In a meeting of the National Energy Committee in October, Premier Li Keqiang argued that coal and “green” mining – utilizing more environmentally responsible coal-mining practices, including waste reduction and control measures – should be expanded to preserve energy security and winter heating capacity. Media reports claimed that China’s new planned domestic coal assets in 2019 would be equivalent to the coal capacity of the entire European Union. Although renewable energy has rapidly expanded in China and per-unit costs have declined, some policymakers still perceive it as unreliable. They want to ensure China has enough energy capacity to support renewed economic activity in the five-year period ahead – be it fossil or renewable.

China is also backsliding on its environmental pledges internationally. Though China officially promotes a climate-friendly “Green” Belt and Road, including through a 2017 implementing opinion from the Ministry of Ecology and Environment (MEE), Chinese firms are increasingly building new coal plants abroad. One widely cited report from energy nonprofit Institute for Energy Economics and Financial Analysis (IEEFA) found that Chinese financing was responsible for 26% of all new planned and committed coal plants outside the country in 2019. Although China ratified the Paris climate accords and pledged to reach peak emissions by 2030, it has also refrained from making new commitments to cut greenhouse emissions and has reiterated its position that developed countries should provide financing to developing countries to help reduce emissions. This is driven by Beijing’s desire to support its flagship Belt and Road Initiative, domestic employment, and activity in the industrial sector. On September 24, State Councilor Wang Yi declined to commit China to new emissions targets in 2020, a key goal of the 2015 United Nations Climate Change Conference (COP). Wang clarified that China will stick to its existing commitments, which are insufficient to prevent a global temperature rise of 2 degrees Celsius, according to experts. This presaged China’s actions at the COP 25 conference in December 2019, where it successfully pushed to scrap language calling on countries to upgrade their emissions pledges in 2020.

Financial System

The Story So Far

Modern economies rely on complex financial systems to support growth and prosperity. At an earlier stage of development, China succeeded despite an immature financial system, as state-led investments in sectors such as infrastructure generated high returns. Today's requirements are more complicated, and the risks are apparent. China's financial reform goals include improving efficiency (return on investment) and reducing systemic risk while attempting to preserve state influence. China has made progress, but long-standing tasks remain unfinished as the cost of retiring old liabilities swells and new risks emerge. The 2013 Third Plenum Decisions promised market-driven liberalization of the system in the form of additional entry opportunities for smaller and private financial institutions, market-driven interest rates and exchange rate formation, and additional capital account liberalization.

- Regarding interest rate liberalization, Beijing removed a floor on lending rates in July 2013. In 2015, Beijing gradually increased the ceilings that banks could offer on deposit rates and then removed them entirely in October 2015. While formal constraints have been lifted, banks continue to limit full market pricing of deposits, reportedly because of informal guidance from regulators.
- Exchange rate liberalization has progressed along a rocky path, as there is still considerable evidence of People's Bank of China (PBOC) intervention in the foreign exchange markets. After a poorly communicated adjustment to the currency's daily fixing mechanism produced a shock depreciation in August 2015, RMB movements have become much more volatile. While markets have a freer hand to adjust the RMB's value, the central bank's intervention is also persistent, reducing benefits of market determination.
- In late 2016, Beijing launched an aggressive deleveraging campaign to reduce systemic financial risks that were accumulating from the growth of shadow banking activities. Despite a slowdown in economic growth, the campaign has continued, substantially reducing credit growth in China and tightening regulations around the financial system.
- Foreign investors' participation in China's financial markets has increased, and Beijing is encouraging foreign portfolio inflows in particular, with the expansion of programs such as the Bond Connect and

Hong Kong–Shanghai Stock Connect starting in 2015. In 2018, foreign investors were key marginal investors in China's government bond market and exercised significant influence over China's domestic interest rates. In April 2019, Chinese securities were added to the Bloomberg Barclays Global Aggregate Bond Index, a major benchmark for global bond investors, for the first time.

Methodology

To gauge the state of financial system reform, we construct a quarterly incremental capital output ratio (QuICOR) as an acid test for efficiency; then we discuss the policies giving rise to this picture. The indicator tells us how much investment occurs relative to one unit of output growth: a lower ratio is better, with 3.5 recognized as high quality internationally, according to International Monetary Fund (IMF) guidance. To supplement this analysis, we look at other indicators, including total credit growth rates, the ratio of stock and bond financing to less direct channels, interbank lending rates, return of household savings, and foreign bond holdings.

Quarterly Assessment and Outlook

Primary Indicator: Incremental Capital Output Ratio

4qma, ratio value



Source: International Monetary Fund, National Bureau of Statistics, Rhodium Group.

- Our assessment is neutral this quarter, with indicators moving in both directions. Shadow banking activity continued contracting, a positive in light of the poor regulation of the segment, but a negative for the outlook for private sector credit access. Overall, the financial system is still becoming less efficient.
- Credit growth is slowing, regulatory controls on shadow banking channels remain in place, and direct financing via the bond and equity markets is improving slightly.

- Rising credit stress points to more realistic pricing of financial risks. Banks have defaulted and been restructured, and state-owned enterprises (SOEs) along with local government financing vehicles have defaulted on both onshore and offshore bonds.

This Quarter's Numbers

Despite efforts to improve market pricing of capital and to introduce new credit risk discipline into China's financial system, financial efficiency continued to deteriorate. Our **Quarterly Incremental Capital Output Ratio (QuICOR)** rose to 7.46 in 3Q2019 from 7.41 in the previous quarter and 7.21 at the end of 2018, which suggests that capital expenditures generated less economic growth. Reluctance to allow politically important, indebted firms and localities to fail means they continue to receive new credit, reducing financial efficiency.

Overall **Growth in Credit** slowed in the second half of 2019 in tandem with the broader economy. Two factors were responsible: the crackdown on shadow banking and the unintended market reaction to the default of Baoshang Bank in late May, which made it difficult for many banks to extend credit. Bank asset growth slowed to 8.2% in September from a recent peak of 9.0% in May, while loan growth slowed to 12.5% from 13.3% in the second quarter.

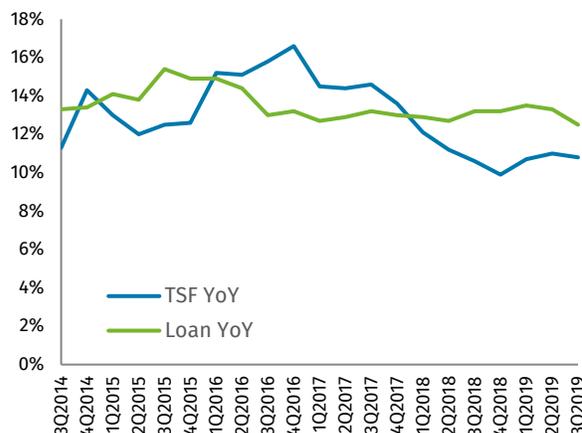
Falling money market interest rates helped make corporate bond issuance more attractive this quarter, thereby increasing direct financing to 19.2% of total financing in 3Q2019 (**Direct Financing Ratio**). Lower rates also effectively compressed the gap between interbank funding costs for deposit takers like banks and nonbank financial institutions to only 0.08 percentage points (**Interbank Lending Rates**). While this small spread indicates that riskier nonbank institutions are not under pressure from higher funding costs, regulatory tightening measures, including new restrictions on wealth management products (WMPs), have continued to squeeze shadow financial institutions.

One of the most closely watched indicators of reform is the growth of foreign participation in China's financial markets, particularly within its bond market – a proxy of Beijing's tolerance for greater market determination of domestic interest rates. The proportion of **Foreign Held Bonds** in China's bond market increased only slightly, to 2.2% in 3Q2019 from 2.1% in the previous quarter. In gross terms, foreign participation has increased more sharply, with around \$215 billion in new inflows into China's bond market over the past two years, according to State Administration of Foreign Exchange data. In addition, foreign ownership of China's government bonds and

policy bank bonds has increased in recent years, consistent with the inclusion of China's securities in global indices.

Supplemental 1: Growth in Credit

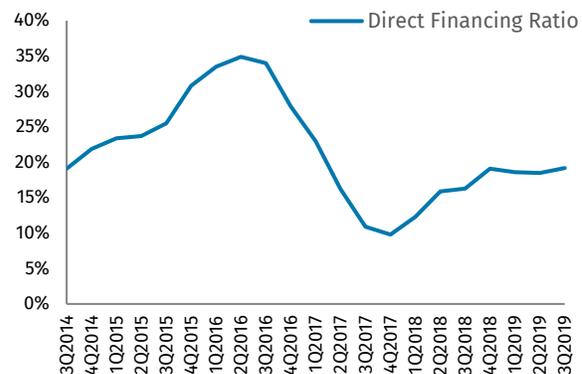
Percent



Source: People's Bank of China.

Supplemental 2: Direct Financing Ratio

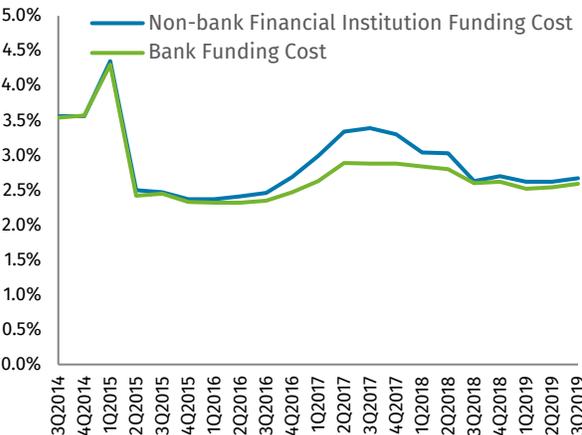
4qma, percent



Source: People's Bank of China, China Securities Regulatory Commission.

Supplemental 3: Interbank Lending Rates

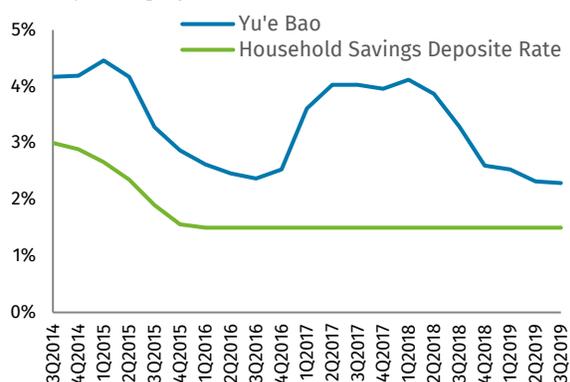
Quarterly average, percent



Source: National Interbank Funding Center, China Central Depository & Clearing Co.

Supplemental 4: Return on Savings

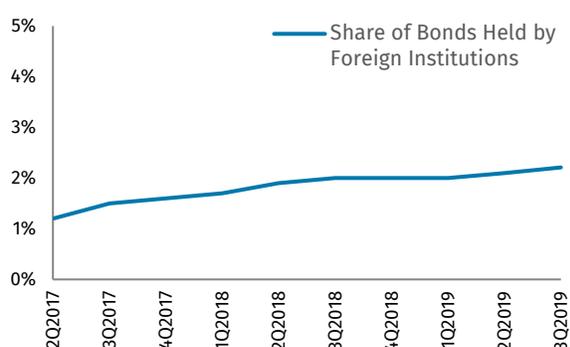
Quarterly average, percent



Source: People's Bank of China.

Supplemental 5: Foreign Held Bonds

Quarterly average, percent



Source: ChinaBond, Shanghai Clearing House, Rhodium Group.

Policy Analysis

Policy efforts this quarter focused on increasing the market influence on bank lending rates. In August 2019, the People's Bank of China (PBOC) introduced reforms tying banks' lending rates (via the loan prime rate, or LPR) to their funding costs (see **Fall 2019 Edition**). This reform theoretically allows market-driven rates to play a greater role in loan pricing by allowing banks to price new loans based on the LPR rather than the previous benchmark rates. In December, the PBOC went further by requiring banks to price *existing* loans based on the LPR as of the end of March 2020. The new requirement should help reduce overall funding costs for the real economy, but it also means banks will face more balance sheet pressure and limit lending growth as they become more discerning in extending credit to riskier borrowers.

At the same time, the lending rate has not yet fallen significantly in response to market pressures because it is tied to another administratively set policy rate, the medium-term lending facility (MLF) rate, which prices to banks' funding. While banks set the LPR, the central bank sets the MLF rate. Banks need the PBOC to lower their

funding costs to reduce lending rates to borrowers. Meanwhile, deposit rate liberalization has not progressed at all, as the central bank still informally caps bank deposit rates at 1.5 times the benchmark. As a result, a significant proportion of banks' funding is still priced by policy rather than market forces.

Credit events are becoming more frequent, which is positive for reform, although they carry considerable risks. Over the past several months, China's financial system has seen a series of new defaults by state-owned enterprises (SOEs), local governments, and banks. In 2019, the most important of these defaults was Baoshang Bank's failure on May 24 (see **Fall 2019 Edition**). The effects of Baoshang's default are still being felt, as smaller banks are facing tighter funding conditions in the interbank market and have been unable to grow their balance sheets as quickly.

Recently, SOEs and local governments have defaulted on onshore and offshore bonds. The government of Tianjin was unable to provide sufficient support for one of its SOEs, Tewoo, which defaulted on a \$1.5-billion U.S. dollar-denominated bond. (Notably, the severity of debt-to-local GDP conditions is now understood to be far worse than previously believed in Tianjin following a recent 29% downward restatement of its 2018 economic output.) In addition, a local government financing vehicle (LGFV) in Hohhot, Inner Mongolia, defaulted on a domestic bond for the first time, while a Qinghai LGFV defaulted on an offshore bond earlier in 2019. These are all watershed credit events within China's financial system; while potentially dangerous for the overall economy, they are critical to improved market pricing of credit risks.

Steps toward financial sector liberalization and greater foreign ownership of financial companies will face a critical stage in early 2020. So far, China's leaders continue to offer additional opening to foreign participation. Both Premier Li Keqiang and PBOC Governor Yi Gang have committed to lifting foreign equity caps in the brokerage and insurance industry with concrete timelines for these opening steps in 2020 (see **Cross-Border Investment**). Foreign firms are allowed to fully own subsidiaries that offer life insurance and engage in futures trading at the start of the year. April 1 will mark the start date for foreign firms to apply for licenses for fully owned asset management firms. The Phase 1 U.S.-China trade deal signed on January 15 reiterated Beijing's financial opening commitments. The promises are not new, and even if fulfilled, foreign firms still may face obstacles to operating freely within China's financial markets. Lifting equity caps and actually facilitating foreign participation in China's financial markets are essential preconditions for improving overall efficiency.

Fiscal Affairs

The Story So Far

China's fiscal conditions are on an unsustainable path. Local governments spend much more than they take in, forcing them to rely on inefficient state-owned enterprises (SOEs), land sales, and risky debt-driven financing practices for revenue. This increases underlying risks and makes the economy less efficient. Leaders in Beijing acknowledge that center-local fiscal reform is critical, and that it has a long way to go. The 2013 Third Plenum plans promised to close the gap between what the center commands local governments to spend and the resources available to them.

- Beijing passed a new budget law in August 2014 that allowed local governments to issue bonds while banning all other forms of local government borrowing and guarantees, including the use of local government financing vehicles (LGFVs) to borrow from banks and the shadow banking sector. The law was meant to limit quickly growing local government debt levels—particularly riskier “implicit debts” or contingent liabilities—that are not recorded on official balance sheets.
- In March 2015, Beijing initiated a three-year “swap bond” program to compel local governments to swap all nonbond borrowing into lower-cost bonds. At the end of 2014, local governments had a reported 14.34 trillion RMB (\$2.1 trillion) in official debt. As of October 2018, only 256.5 billion RMB (\$37 billion) of this debt remained to be swapped. The program improved local fiscal transparency and reduced interest burdens for local governments and has been extended on a limited basis in 2019.
- The central government initiated value-added tax (VAT) reform in 2012 in pilot form and officially rolled out the VAT nationwide in 2016. The VAT replaced China's complex business tax with a more simplified scheme meant to cut the corporate tax burden. In practice, the VAT decreased local government tax revenue on net, given that it offered more tax deductions and was in many ways a tax relief relative to the business tax scheme.
- Recognizing that the 2014 budget law had not succeeded in curtailing off-balance-sheet borrowing by local governments, in early 2018, Beijing required that local governments repay all associated contingent liabilities or implicit debt within three to five years. While the exact amount of local government implicit debt is

unknown, credible estimates put the actual level at 30–45 trillion RMB (\$4.3–\$6.5 trillion) as of today. Since the heavy debt burden has been crippling for localities, Beijing relaxed guidance on debt repayment in October 2018, allowing local governments to extend or renegotiate implicit debts.

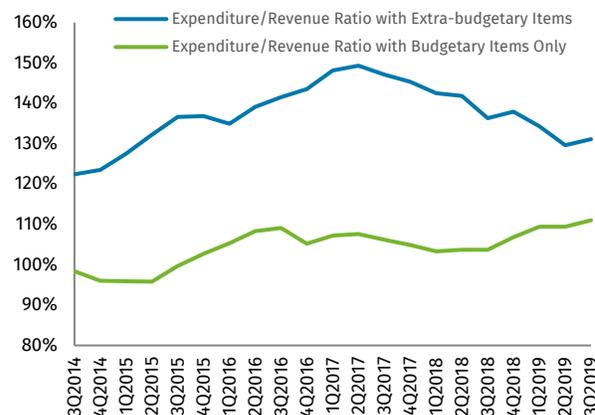
Methodology

To gauge fiscal reform progress, we watch the gap between local government expenditures and the financial resources available to pay for them, including central government transfers. Our primary indicator shows the official trend in blue and an augmented calculation of the gap (including off-balance-sheet or “extrabudgetary” expenses and revenues) in green, thus covering the range of estimates. The higher the expenditure-to-revenue ratio, the more concerning the side effects, including local government debt burdens. Our supplemental fiscal indicators include local financing sources, the national official and augmented fiscal position, the move from indirect to direct taxes, and the share of expenditures on public goods.

Quarterly Assessment and Outlook

Primary Indicator: Local Governments Expenditure-to-Revenue Ratio

4qma, percent



Source: National Bureau of Statistics, Rhodium Group.

- Fiscal affairs reform has progressed over time but remained flat this quarter. Local governments reported shrinking revenue, resulting in a larger fiscal gap. On the upside, Beijing is moving to allow more tax intake for local governments.
- The local government augmented fiscal gap widened slightly in 3Q2019 led by a decline in bond issuance and tax revenue, while spending expanded modestly.

- By increasing local government tax revenue, Beijing’s proposed consumption tax reform is a step in the right direction but could slow momentum toward more impactful and necessary tax reforms in the near term.

This Quarter’s Numbers

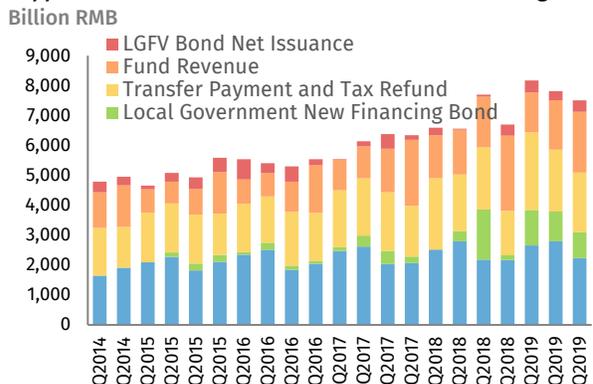
The gap between what local governments spend and what they take in expanded this quarter, contrary to the objective of fiscal affairs reform. The augmented **Local Expenditure-to-Revenue Ratio** increased slightly to 131% in 3Q2019 from 130% in the previous quarter, below 136% in 3Q2018. Declining revenue from both budgetary sources and local government bond issuance drove modest deterioration of the local fiscal balance. Net local bond issuance registered 13% lower than the previous quarter and 49% lower than the third quarter of 2018, as fiscal support was backloaded in 2018 and frontloaded in 2019 to offset weaker growth. Local issuance will be seasonally low in the fourth quarter, maintaining the pressure.

Tax revenue also took a hit in 3Q2019, plunging 20% quarter-on-quarter. Weaker economic growth drove the decline. The sharp fall in corporate income tax resulted from slowing cyclical momentum and heavy deflationary pressure that eroded corporate profitability. Individual income tax decreased following the implementation of 2019 changes that raised income tax thresholds and gave additional tax breaks, in hopes of spurring consumption.

An increase in land-related revenue prevented a sharper decline in local government resources. Local government fund revenue, most of which comes from land sales, rose 20% compared with 3Q2018 and was 10% higher than 2Q2019. With property developers reporting an 11.4% decline in land transactions in 2019, this pattern is unsustainable: collection of payments lags land transactions and is bound to fall in 2020.

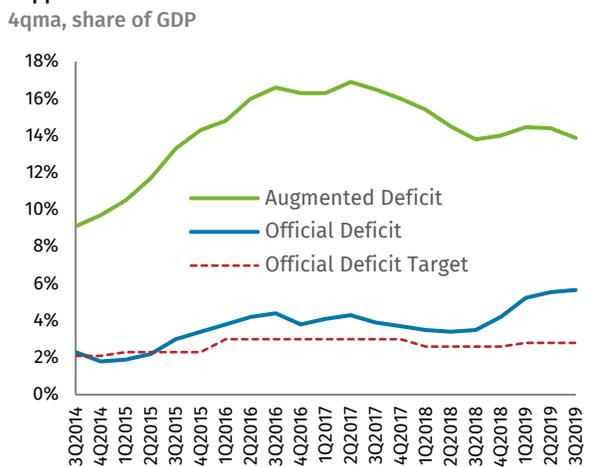
Local spending on social services as a share of total expenditure reported a modest uptick in the third quarter with improvement mainly from social security expenditure, money spent on paying salaries and subsidies to retired and unemployed persons (see **Government Social Expenditures**).

Supplemental 1: Sources of Local Government Financing



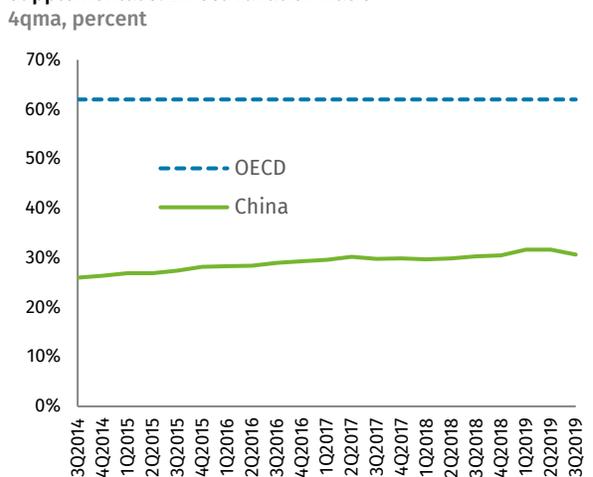
Source: Ministry of Finance, National Bureau of Statistics, International Monetary Fund, Rhodium Group.

Supplemental 2: Fiscal Deficit Measures



Source: Ministry of Finance, Rhodium Group.

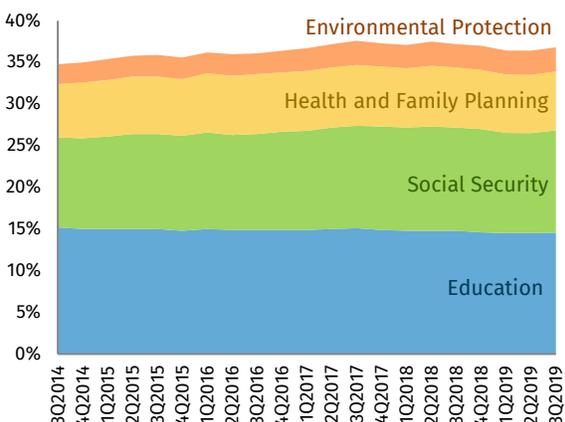
Supplemental 3: Direct Taxation Ratio



Source: OECD, Ministry of Finance, Rhodium Group.

Supplemental 4: Government Social Expenditures

4qma, percent



Source: Ministry of Finance, Rhodium Group.

Policy Analysis

The most important development in late 2019 was the central government’s proposed consumption tax reform, which will expand the tax base and increase central revenue sharing with local governments. The Ministry of Finance named this as a 2020 priority; the new draft law will undergo several rounds of legislative review and likely be approved as early as 2020. If implemented, the change would increase local governments’ intake and relieve some of the fiscal pressures they face amid shrinking land sales revenue.

Currently, the central government collects consumption taxes and disperses a portion back to localities via transfers. The proposed reform will shift consumption tax collection from producers and wholesalers to the consumer-facing retail side. While the central government will continue to collect a base tax at the current level, local governments would retain marginal revenue collected above the base level. The consumption tax accounts for 8% of total tax revenue; in the first 11 months of 2019, consumption tax revenue rose 19.4% year-on-year, bucking the 0.5% slowdown in overall tax intake growth.

Consumption tax reform is one step toward fixing the uneven status quo wherein local spending responsibilities exceed permitted fiscal intake, as the central government takes the lion’s share of tax revenues. As a result, although local governments have historically relied on land sales revenues, the deteriorating property outlook makes it unrealistic to count on this going forward. Land sales revenue only grew 8.1% for the January-November 2019 period, compared with a 25% rise in 2018 and a 40.7% increase in 2017. Localities urgently need new sources of revenue to narrow the gap.

So once again, policymakers are left with the alternative to tax and redistribution: running up debt. Beijing’s budget will determine localities’ fiscal balance – including how much local governments are allowed to issue in special revenue bonds (SRBs), which have been the main support for fiscal balances in recent quarters. In 2019, local governments’ SRB quotas increased by 800 billion yuan (\$114 billion) to 2.15 trillion yuan (\$305 billion), sharply higher than the 550 billion yuan increase reported in 2018. Chinese media reported a 2020 SRB quota of 3 trillion yuan, another 850 billion yuan increase over 2019. The official quota will be announced ahead of the March “Two Sessions” gathering of policymakers.

All of this – including whether there is a March congress – depends on the course of the coronavirus pandemic sweeping the nation. As we look ahead, it is likely that the need for outlays will boom and the size of tax revenues will shrink greatly.

Innovation

The Story So Far

Innovation drives economic potential, especially as incomes rise and workforce and investment growth moderate. Promoting innovation is more difficult than cutting interest rates or approving projects. Innovativeness within an economy is an outcome reflecting education, intellectual property rights (IPR) protection, marketplace competition, and myriad other factors. Some countries have formal innovation policies and some do not, and opinions vary on whether government intervention helps or hurts in the long run. Many Chinese, Japanese, and other innovation policies have fallen short in the past, while centers of invention in the United States such as Silicon Valley, Boston, and Austin have succeeded with limited government policy support. In other cases, innovation interventions have helped, at least for a while.

- The 2013 Third Plenum released a series of decisions aiming at improving the innovation environment in China. Compared with previous innovation strategies, the Third Plenum placed a greater emphasis on market forces, calling for “market-based technology innovation mechanisms” while announcing that the “market is to play a key part in determining innovation programs and allocation of funds and assessing results, and administrative dominance is to be abolished.”
- In May 2015, China officially launched Made in China 2025 (MC2025), a 10-year strategic plan for achieving new levels of innovation in emerging sectors. The MC2025 agenda diluted the Third Plenum’s emphasis on market mechanisms with more elements of central planning. The blueprint set performance targets for 10 key industries in the proportions of domestic content and domestic control of intellectual property. An associated implementation road map document laid out specific benchmarks for global market share to be achieved by Chinese firms in emerging sectors, generating significant international backlash.
- Recognizing the prevalence of subsidy abuses and excess capacity related to its industrial policy programs, Beijing announced in December 2017 that it would gradually phase out some subsidy programs, such as for photovoltaic power generation and new energy vehicles (NEV).
- In March 2018, the U.S. Trade Representative’s Section 301 Report concluded that key parts of China’s technology push, including MC2025, were

“unreasonable or discriminatory and burden or restrict U.S. commerce.” The United States then imposed trade tariffs on \$250 billion worth of Chinese imports over the course of 2018, including some products related to MC2025 and many that were not.

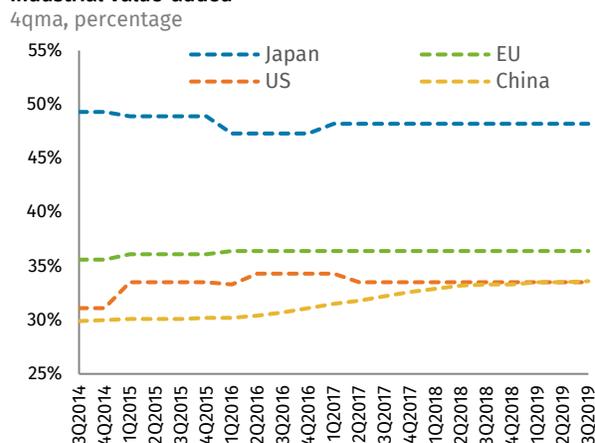
- In May 2019, the U.S. Trade Representative raised tariffs from 10% to 25% on nearly \$200 billion of goods from China and started to review tariffs on the remainder of imports from China. Beijing retaliated by raising tariff rates on some imports from the United States. The U.S. Department of Commerce also added several Chinese high-tech manufacturers to its “Entity List”—a list of companies believed to present national security risks to the United States—effectively restricting those firms’ access to U.S. exports.

Methodology

China’s goal is to grow innovative industries and prune low-value sunset sectors. Indicators such as patent filings are increasing, but analysts question their quality. To measure progress, we estimate the industrial value-added (IVA)—a measure of meaningful output—of innovative industries as a share of all IVA in China, which tells us how much innovative structural adjustment is happening. Because China does not publish all IVA data details, we use an indirect approach to do this. Our supplemental gauges look at value-added growth rates in specific industries, China’s performance compared with that of advanced economies in specific industries, China’s trade competitiveness in innovative products, and two-way payments flows for the use of intellectual property.

Quarterly Assessment and Outlook

Primary Indicator: Innovation Industry Share in Industrial Value-added



Source: OECD, National Bureau of Statistics, Rhodium Group.

- Our assessment of China’s innovation reform progress in 3Q2019 is neutral. The weight of innovative industries in China’s economy increased only slightly – and not enough to indicate progress.
- While five out of the seven innovative industries we track outperformed average industrial activity, one capital goods industry (universal equipment) fell below the industry average, joining the auto industry. The economy-wide slowdown is weighing on medium and high-tech industries that benefit from government support.
- Beijing made efforts to improve intellectual property protection. International policy alignment to counter China’s industrial policy practices is emerging, which could slow China’s innovation progress.

This Quarter’s Numbers

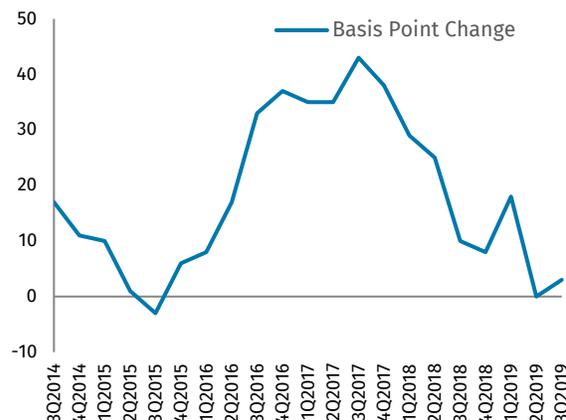
Innovative sectors did not play a bigger role in China’s economy this quarter. Our primary indicator, **Innovative Industry Share in Industrial Value-Added (IVA)**, did display a small uptick (0.03 percentage points on a four-quarter moving average basis), but the increase is too small to be considered noteworthy. As of 3Q2019, innovative manufacturing sectors accounted for 33.6% of total value-added in China’s secondary industry – on par with the U.S. level in 2017, but below the European Union average (36.4% as of 2017).

Preferential policies did not insulate innovative industries from the growth headwinds facing China’s industrial sector. Five out of the seven innovative industries we track (**Industrial Value-Added Growth Rates for Specific Innovative Industries**) continued to grow above the reported industrial sector average (6.2% year-on-year, on a four-quarter moving average basis). However, universal equipment manufacturing fell below the 6.1% industrial average for the first time since 2017, making it the second innovative industry after auto (-0.7%) to become a drag on our innovation proxy. The universal equipment manufacturing industry produces capital goods used in other industrial activities, thus exposing it to the broad industrial slowdown underway.

Intellectual property (IP) rights protection is essential for innovation, yet China’s payments for the use of foreign patents, trademarks, copyrights, and industrial processes have not increased meaningfully since 2017. In 3Q2019, China paid \$8.6 billion in IP royalties to other countries (see **Intellectual Property Flows**). Beijing committed to increase total U.S. services imports by \$37.9 billion (from 2017 levels) over the next two years as part of the U.S.-China Phase 1 deal. Looking ahead, this indicator will be

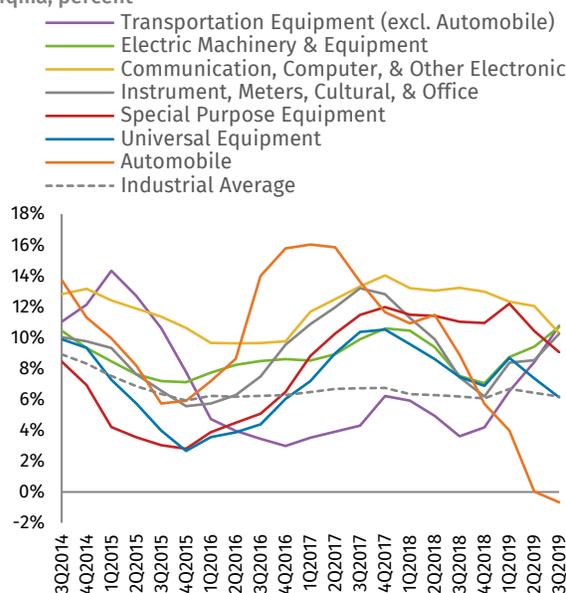
monitored to gauge the implementation of that commitment, although the coronavirus outbreak starting in December has halted activity in China and will impact services trade flows and economic growth broadly in the first half of 2020.

Supplemental 1: Volatility in Innovative Industry
4qma, bp



Source: National Bureau of Statistics, Rhodium Group.

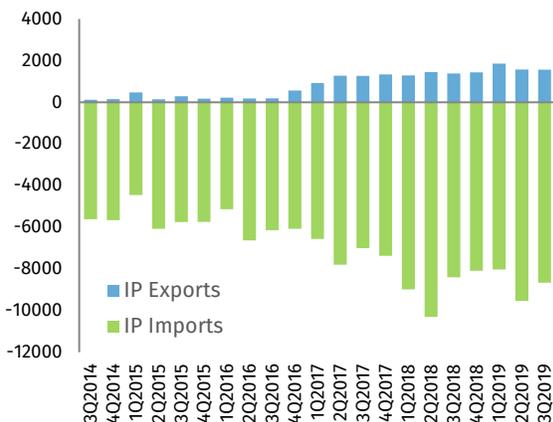
Supplemental 2: Industrial Value-Added Growth Rates for Specific Innovative Industries
4qma, percent



Source: National Bureau of Statistics, Rhodium Group.

Supplemental 3: Intellectual Property Flows

USD Million



Source: National Bureau of Statistics, Rhodium Group.

Policy Analysis

IP protection was a major theme in China’s innovation policy discourse this period. For years, China has made commitments to improve the domestic IP regime, but progress has been slow at best. In recent quarters, leadership emphasized the focus on IP protection – partly due to heightened pressure from the United States and other advanced economies, and partly because more domestic innovators now stand to benefit from better IP protection at home and abroad.

On November 24, the State Council and the Chinese Communist Party (CCP) released a joint policy guidance on IP protection, marking the first time that the Party and the government issued public IP-related guidance together. Titled “Opinion on Strengthening IP Protection,” the guidance instructs authorities to improve the domestic IP legal framework by strengthening enforcement and coordination across agencies. In particular, the opinion emphasizes that in infringement cases, the accusing party’s burden of proof should be relaxed. This is significant and could lead to real improvement across different levels of the government. In fact, recent legal revisions referenced by the opinion, such as the draft Patent Law, have been fast-tracked on the legislative agenda and could be implemented as early as the first half of 2020.

The Foreign Investment Law Implementing Regulations, which went into effect on January 1, 2020, feature two articles addressing IP issues. Article 24 promises swift enforcement and punitive compensation, while Article 25 reemphasizes that no official should force foreign investors to transfer technology. The scope of these reassurances is limited, and the regulations lack important detail.

The Phase 1 agreement reached by the United States and China on January 15 features two sections covering a plethora of IP issues ranging from trade-secret protection to licensing requirements. Some commitments serve to institutionalize changes already made (such as China’s recent revision of the Anti-unfair Competition Law); others are promising but lack implementation rules (such as shifting the burden of proof in civil proceedings to the accused). Overall, China is likely to implement these commitments in campaign-style enforcement actions, which would present encouraging statistics but might lack long-term sustainability.

Taken together, China has made efforts to improve its domestic IP regime due to both external pressure and internal necessity. But the speed, direction, and impact of these steps will likely remain mixed. One major structural constraint to effective reform is China’s anti-competitive industrial policy approach. On December 5, the Ministry of Industry and Information Technology (MIIT) published its “New Energy Vehicle Industry Development Plan (2021–2035).” The plan features hallmarks of state-led industrial policy: government-set market share targets, emphasis on self-controlled technology, and subsidies. The new MIIT plan increased the 2025 new energy vehicles sales target from the previous 20% to 25% (of all vehicles sold), heavily emphasized indigenous technology, and promised subsidy and financing support to boost growth.

China’s industrial policy is drawing increasing international backlash. On January 14, the European Union, Japan, and the United States issued a trilateral Joint Statement, including proposals to curb industrial subsidies. While not China-specific, the document states that existing World Trade Organization rules are insufficient to address distortions caused by state subsidies and financing. The three contributors specified certain subsidies that should be prohibited and others where the burden of proof should be shifted away from the complainant. If implemented, many Chinese innovators, which export or operate overseas, could face significantly higher business costs, given the omnipresent nature of government support in the manufacturing sector. The quickly changing external environment thus places China’s innovation reform at a critical juncture: the new way is not yet fully developed, but the old way is under the spotlight of China’s trading partners.

Labor

The Story So Far

From the birth of the People's Republic of China in 1949 to 2015, China's working-age population grew by 600 million people: it is little wonder economic output expanded. Today, the size of the workforce is shrinking, so improving both its quality and mobility is critical for longer-term competitiveness. The share of Chinese people living in cities is also slated to rise to 60% by 2020, adding huge growth potential but also increasing fiscal pressure on local governments to deliver social services. China's 2013 Third Plenum called for labor policy reforms to boost job creation and entrepreneurship, discourage discrimination and labor abuse, improve income distribution, fund social security and pensions, and enhance healthcare and education.

- In July 2014, authorities issued an *Opinion* that called for relaxing the burdensome restraints on individuals who wished to change their residency (the household registration or *hukou* system). This new policy eased controls for those wishing to move to smaller cities while leaving in place more restrictive measures for those wishing to move to bigger cities. Policymakers also planned to set up a nationwide residency permit system that would ease and standardize the process of relocating.
- In December 2015, the central government established that anyone living in one locality for six months could apply for a residency permit and therefore gain access to basic social services. The measure softened the division between rural and urban *hukou*, and it laid a basic foundation for the abolishment of the *hukou* system over the longer term.
- A notice issued in August 2016 recommended fiscal support to incentivize and facilitate urbanization and provide social services based on the newly established residency permit system. The extent and effectiveness of this support are still unclear.
- In February 2018, China's State Council indicated that it would share more social expenditures with localities. Local governments have long shouldered a disproportionate share of overall government spending while suffering from weak sources of revenue; more revenue from the center would help bridge this gap.

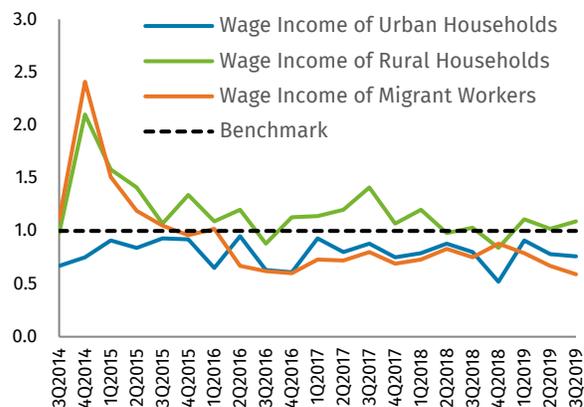
Methodology

To assess progress in China's labor policy reforms, we chart wage growth for the segment of the labor force most

likely to present a bottleneck to the country's productivity: migrant workers. Working away from home in temporary and low-skilled jobs and with little access to urban social services, migrant workers have supported China's growth miracle, but they are increasingly vulnerable to structural changes. Our primary indicator charts the growth rate of migrant worker wages relative to the GDP growth rate. If wage growth trails GDP growth, it suggests falling productivity or inadequate policy support for the workforce, or both. The wage/GDP growth trend for other segments of the workforce is also included. Divergence in income gains between segments can lead to social unrest, as can downward trends impacting all segments simultaneously. Our supplementary indicators look at job creation, labor market demand and supply conditions, urban-rural income gaps, and social spending relevant to labor outcomes.

Quarterly Assessment and Outlook

Primary Indicator: Wage Growth Relative to GDP Ratio



Source: National Bureau of Statistics, Rhodium Group.

- Our assessment is negative this quarter, a further downgrade from last quarter. Almost all labor indicators deteriorated, meaning workers did not share equally in economic growth.
- Urban and migrant workers saw wage growth lag economic growth, and businesses are creating fewer jobs amid the broader slowdown. Fiscal spending to directly support workers was minimal.
- On the policy side, Beijing adopted measures to stabilize employment, increase wage incomes, and alleviate poverty to improve labor conditions and social welfare in the future.

This Quarter's Numbers

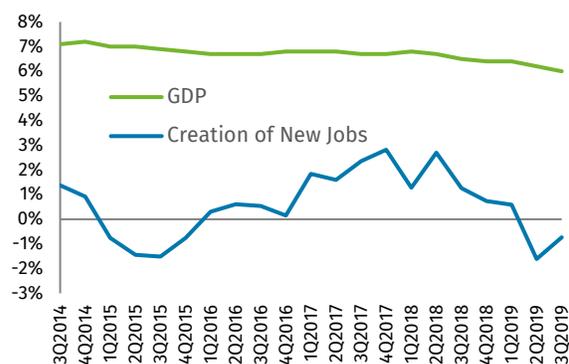
China's slowdown extended into 3Q2019 on the back of weaker lending and investment growth, revealing the constraints firms are facing in hiring new workers and raising wages. Wage growth did not keep pace with economic growth for most of China's workforce in 3Q2019. Our primary indicator, **Wage Growth Relative to GDP**, shows migrant wages growing by the slowest pace since the series began reporting in 2013, while urban wage growth also lagged economic growth. When workers do not get to share in GDP growth, they are left with shrinking wealth and are discouraged from making long-term investments in education and skill development, weighing down future potential growth.

The only bright spot this quarter was the modest upturn in rural income growth relative to economic growth, but this improvement may be temporary for several reasons. First, agriculture prices were elevated due to U.S.-China tariffs as well as the impact of African swine flu on pork supply, likely boosting farm incomes. Second, while rural nonagricultural land reform remains stalled, agricultural land has benefited from policies that allow farmers to scale up agricultural operations (see **Land**). Despite this progress, however, urban households still earn 2.7 times more disposable income than rural households do – an improvement from 3.1 in 2010 – though the wealth gap has not narrowed meaningfully since 2016 (see **Rural-Urban Household Income**).

Employment data remain weak. There were 100,000 fewer jobs created in the four quarters ending in 3Q2019 than the year prior (see **New Job Creation**). Meanwhile, authorities inexplicably failed to report the ratio of job openings to applications this quarter (see **Labor Demand-Supply Ratio**). In 2Q2019, demand for labor relative to supply dropped in all regions, especially in Eastern and Western China; were the data available, they would likely show job openings per applicant dropping further in the third quarter. Even so, fiscal support to offset these pressures was minimal, with social security and employment-related spending rising half of a percentage point since 2Q2019 relative to GDP (see **Social Spending**).

Supplemental 1: New Job Creation

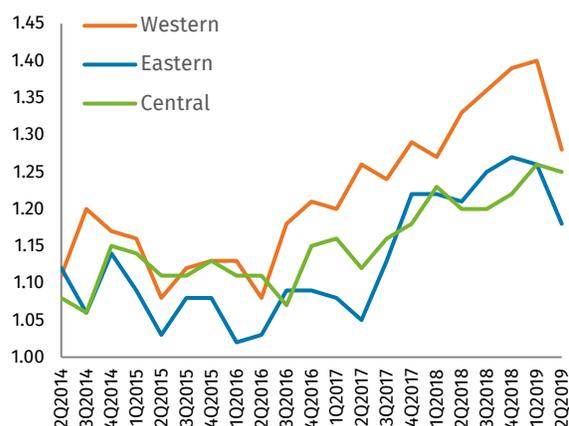
Yoy, percent



Source: Ministry of Human Resources and Social Security, National Bureau of Statistics.

Supplemental 2: Labor Demand-Supply Ratio

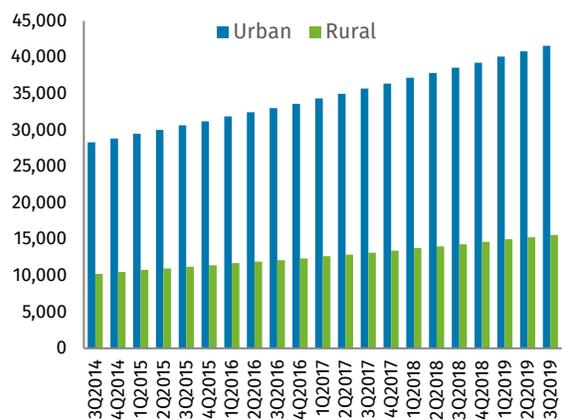
Job openings per applicant



Source: Ministry of Human Resources and Social Security.

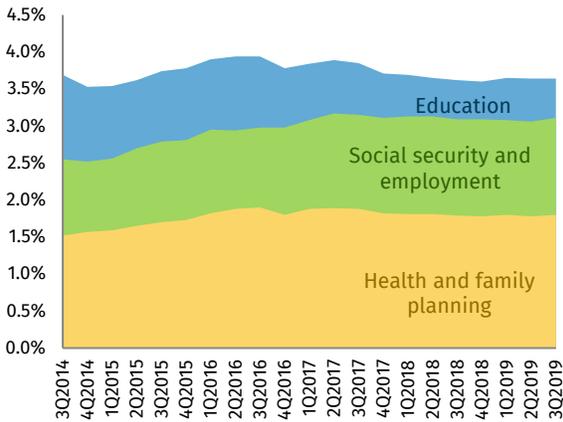
Supplemental 3: Rural-Urban Household Income

Annualized RMB



Source: National Bureau of Statistics.

Supplemental 4: Government Social Expenditures
4qma, percent



Source: National Bureau of Statistics, Ministry of Finance.

Policy Analysis

In light of weakening labor conditions, policymakers stepped up efforts to address labor’s share of income and social welfare in the economy in late 2019. Policies centered on a combination of short-term measures to stabilize employment and the reiteration of longer-term reform goals, including reducing inequality and improving conditions for lower-income workers.

Shoring up weak labor conditions was the priority. A joint statement from the State Council and the Communist Party’s Central Committee called for more job creation and the prevention of widespread unemployment. A December National Development Reform Commission meeting set goals for 2020, emphasizing the need to “stabilize employment by any means necessary.” Policymakers supplemented these statements with a series of measures directly supporting income growth. In December, the State Council issued draft rules to ensure that migrant workers receive timely wage payments and back pay they are owed. The State Council also extended unemployment allowances and incentivized small and medium enterprises to hire more employees, which should boost social spending related to employment in our indicators.

The joint Central Committee statement stressed that better worker mobility was key to improving labor conditions, and that the household registration system, or *hukou*, remains a major impediment. The *hukou* reform plan announced in April 2019 sought to cancel all registration restrictions in cities with fewer than 3 million residents and to significantly relax restrictions in cities with 3–5 million people in 2019. The State Council has pledged to eliminate all *hukou* restrictions by 2022 (see **Summer 2019 Edition**). The Central Committee is now

pushing local governments to provide more public services to migrants and to develop concrete plans for absorbing migrant workers. However, the statement made no provision for the central government to share the greater local social spending burden that would ensue, casting doubt over *hukou* reform prospects.

Authorities also focused on reducing inequality and poverty. The Fourth Plenum of the Party’s Central Committee, an important occasion for setting political priorities, emphasized the need to increase incomes for middle-class and poor workers. At the Central Economic Work Conference (CEWC) in December, leadership elevated poverty alleviation above pollution reduction and financial system deleveraging in 2020. While these plans are light on implementation details, the prioritization of labor policy across party and government offices shows clear upgrading.

Land

The Story So Far

China faces unique land policy reform challenges. Unlike economies where landowners have full property rights, in China rural land is owned by collectives (the rural political unit), and urban land is owned by the state. Rural households can only transfer “contractual use rights” within their collectives, while converting rural land for development use can only happen via state requisition. This incentivizes local governments to expropriate rural land at modest, fixed prices and develop it at a profit, which is a major source of revenue to finance fiscal expenditures. More efficient land allocation is needed to balance urban-rural interests and encourage mobility. Recognizing this, the 2013 Third Plenum reform program pledged to promote agriculture at a commercially viable scale by permitting consolidation of small plots into larger farms, to make rural nonagricultural land marketable like urban land, and to end the hukou (or household registration) system that limits mobility. Replacing land transfers as one of the limited revenue sources available to local governments is another necessary element of land reform.

- In February 2015, Beijing approved a pilot program for 33 counties that allowed rural nonagricultural land to be transferred at market prices, with an intent to treat such land the same as urban land. Among the counties involved, 15 piloted direct sales of rural nonagricultural land in urban land markets, 15 counties were allowed to repurpose rural nonagricultural land designated for residential use for other purposes, and 3 counties experimented with state requisition of land at market prices. These pilot programs were supposed to expire by the end of 2017, but that deadline has been repeatedly extended until the end of 2019.
- In June 2015, Beijing published the results of its first comprehensive audit of land sales nationwide. The audit found considerable evidence of missing revenue and fraud, while also confirming the dependence of local governments on land sales revenue. The audit revealed how easily land-related revenues can be misappropriated within the fiscal system.
- In October 2016, Beijing divided households’ contractual rights to rural agricultural land into “land use rights” and “land management rights.” Land use rights could then be transferred to other households or enterprises as long as the land was used for agricultural purposes, while rural households were allowed to maintain land management rights to receive rental

payments from the use of their land. These measures were meant to encourage more efficient agriculture, incentivize rural households to resettle in cities, and improve rural income from property.

- China revised the Rural Land Contracting Law in December 2018 to codify the division of “land use rights” and “land management rights” and to extend rural residents’ rights to agricultural land for another 30 years. China also revised the Land Management Law in August 2019 to allow rural nonagricultural land to enter the urban land market but only under strict conditions with heavy involvement of the government. This revision is below expectations and will limit the scope of future reform.

Methodology

Given Beijing’s 2013 Third Plenum commitment to make rural nonagricultural land marketable like urban land, our primary indicator for land reform tracks the area of rural nonagricultural land offered in the market for the best purchase price – which we consider “reformed,” the slim red area in the chart. All other rural land remains constrained in terms of marketability. The Ministry of Agriculture and Rural Affairs (MoARA) releases agricultural land turnover data once or twice per year. For rural nonagricultural land, the Ministry of Natural Resources (MoNR) publishes an annual yearbook and holds occasional press conferences on pilot programs. These fragmented data sources are far from adequate. Supplemental indicators look at land requisition financials, newly urbanized land by use, urban land prices, and rural credit. Most of these indicators are updated only annually with a one-year lag. That said, they provide a basic statistical picture of the magnitude of unfinished land reform.

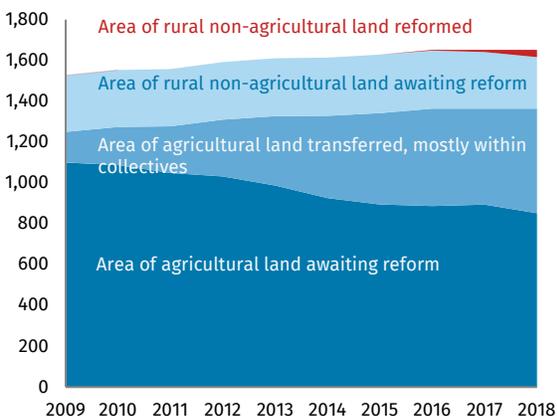
Quarterly Assessment and Outlook

- We maintain our negative assessment of land reform this quarter, as authorities concluded past pilot programs and offered unambitious plans to replace them.
- Rural nonagricultural land transferred at market prices remains just 0.1% of China’s total rural nonagricultural land by area. Local governments still over-rely on land sales to narrow their budget shortfalls, though their ability to do so may be more constrained going forward.
- Beijing announced new pilots for transferring rural land to the urban market. But as with prior experiments, the impact of this is likely to be limited, given that

restrictions remain on reassignment and the legacy of a dual land ownership system.

Primary Indicator: Land Marketized

Million mu (1 mu ≈ 1/6 acre)



Source: Ministry of Agriculture and Rural Affairs, Ministry of Natural Resources, Rhodium Group.

This Quarter's Numbers

No progress on land reform was made this quarter, keeping our assessment in negative territory. With the introduction of a revised Land Management Law in August 2019 and the conclusion of past pilot reforms, the debate about reform direction seems over for now. Policy efforts will focus on implementing the new law, which only grants limited rights to rural residents while reinforcing a strong government role (see **Fall 2019 Edition**). More pilot projects were announced in December, but they are likely to be ineffectual. It is increasingly clear that the time for cautious and modest pilots has passed. Rural nonagricultural land transferred at market prices will remain a tiny fraction of China's total rural nonagricultural land for the foreseeable future.

Local governments continued trying to patch revenue shortfalls with land sales this quarter (see **Land Requisition Financials**). This relies on speculative demand for land from property developers. Two forces constrain localities' ability to continue this pattern in the future. First, at the December Central Economic Work Conference (CEWC), leaders repeated that "houses are for living, not for speculation," squelching rumors of more open national property policies for 2020. This stance, if maintained, depresses land prices, which are already rising at their slowest pace in two years (see **Urban Land Prices**).

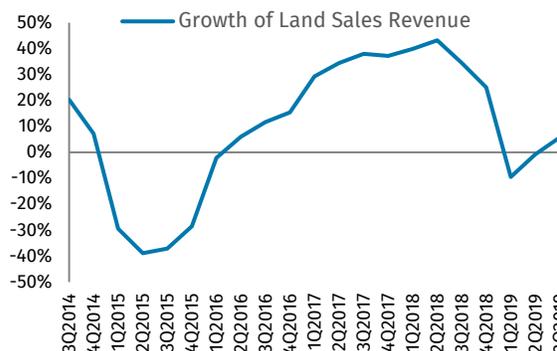
Second, the new Land Management Law effective January 1, 2020, requires local governments to compensate rural residents for expropriated land at "fair and reasonable"

prices based on local conditions rather than on agricultural output values. This significantly lowers the arbitrage margins to local governments from transferring land out of farming and into commercial or industrial use. Governments face shrinking income from land sales, even though they will still turn to it for quick cash in the short term for lack of better options.

While reform of nonagricultural land has delivered minimal impact, Beijing's partial reform of agricultural land still helped improve rural residents' incomes. By 2018, nearly 40% of agricultural land had been leased out for agricultural use, according to official data, allowing farmers to generate some rental income even though not as much as selling the land to the urban market. Growth of rural property income thus accelerated to 10.1% in 3Q2019 from 8.7% in 2Q2019, contributing to a slight improvement in rural disposable income growth to 9.7% from 9.0% (see **Rural Credit**). Farmers' income growth may be overstated: African swine fever is rumored to have destroyed more than half the stock of pork in China. The epidemic may have slowed aggregate farmer income growth over the summer, but that is not reflected in the current data.

Supplemental 1: Land Requisition Financials

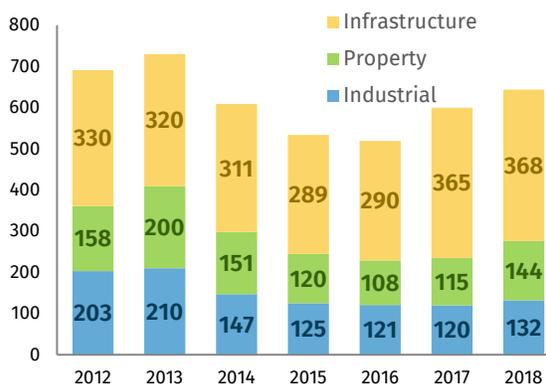
Year-over-year, percent



Source: Ministry of Finance, Rhodium Group.

Supplemental 2: Urban Land Supply by Use

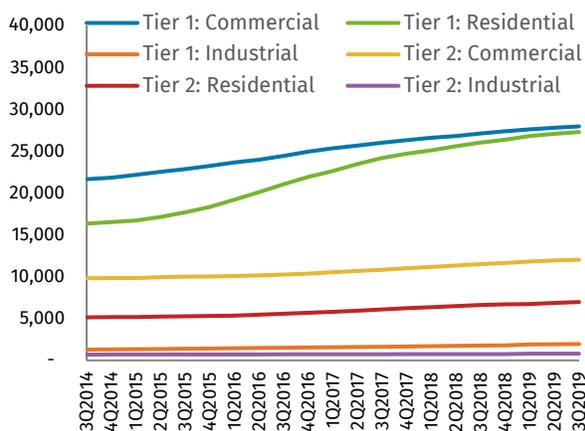
Thousand Ha



Source: Ministry of Natural Resources.

Supplemental 3: Urban Land Prices

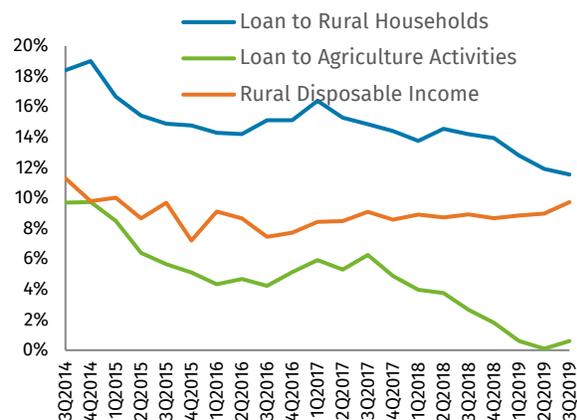
RMB per square meter



Source: Ministry of Natural Resources.

Supplemental 4: Rural Credit

Year-over-year



Source: People's Bank of China, National Bureau of Statistics.

Policy Analysis

Beijing announced a new plan to expand land reform that will likely be ineffectual. On December 30, the National Development and Reform Commission and 17 other government bodies, including MoARA and the Ministry of Natural Resources (MNR), issued a policy promoting urban-rural integration, identifying 10 pilot counties to “establish a mechanism for rural non-agricultural land to enter the urban market” by 2025.

At first glance, this may seem more promising than the previous 33 pilots undertaken between 2015 and 2019. The new project covers a rural and urban land area of 127.5 million mu (21 million acres), 50% more than the 85 million mu (14 million acres) covered by previous pilots, and is situated in economically developed regions including Zhejiang, Shandong, and Chongqing, where land is more valuable than in poorer areas.

However, the scale of pilot expansion is disappointing. The previous pilots transferred 360,000 mu of rural nonagricultural land (59,305 acres, or just 0.1% of China’s total rural nonagricultural land) at market prices over four years. The new pilots at maximum will address less than 1 million mu (165,000 acres) of rural nonagricultural land (0.4% of China’s total) over the next five years.

This is still a timid approach: at this rate, it will take more than a century to get the job done, even though substantial progress was expected by now. Furthermore, these limited transfers will be subject to restrictions. The new plan emphasizes that rural land transfers must conform to official land planning goals while entering the market at a “proper pace.” The meaning of that is not defined and thus subjects the process to local government discretion based on property market interests, politics, and other non-reform-friendly considerations. In other words, the government will still control rural land transfers even though technically rural land is free to enter the urban market.

In addition, the new plan continues to identify rural collectives as the counterparty (i.e., the title holder, “on behalf of” the peasantry who farm it) to rural land transfers, meaning that rural and urban lands are still subject to different ownership structures and therefore are unlikely to be transferred on equal terms. Leaders show no intention of changing this system: the revised Land Management Law preserved the “dual ownership” doctrine that underpins it, and the October Fourth Plenum of the Communist Party leadership offered no new thinking on rural land rights.

State-owned Enterprise

The Story So Far

Reforming state-owned enterprises (SOEs) is critical to improve the competitive environment within China's economy and in overseas markets where Chinese firms are engaged in trade and investment. Unlike other commercial entities, SOEs are tasked with economic and political objectives. The crux of SOE reform is delineating and separating these commercial and political activities.

During the 1990s, Beijing tried to reform the state sector by consolidating state control over large SOEs while withdrawing from small ones, which contributed to private sector prosperity and a decade of strong economic growth. In the 2000s, Beijing redefined SOE "reform" as concentrating state control over key and pillar industries with strategic linkages to China's economic development and national security.

In 2013, the Third Plenum further clarified SOE reform as transforming SOEs into modern corporations, with the state exercising influence in the same fashion as other shareholders. The Third Plenum also envisioned that the state would reduce control of commercial SOEs while pushing SOEs in strategic industries to focus on their "core" business areas.

- Starting in 2014, Beijing tried to improve SOEs' competitiveness using ad hoc measures, such as mergers and mixed ownership programs (similar to those used in the 1990s) involving the sale of minority shares to private firms. These piecemeal efforts continue today. However, none of these measures has been sufficient to reshape SOEs' incentives in line with market principles or redefine their role within the economy.
- In September 2015, the State Council published a new set of "guiding principles" for SOE reform. The document was more conservative than expected. Rather than allowing the market to decide the future of SOEs, the State Council proposed utilizing market mechanisms to make SOEs bigger, stronger, and more efficient, while maintaining control by the government.
- The 2015 guiding principles reiterated a 2013 Third Plenum goal to transform the government's role in managing SOEs from "managing assets" to "managing capital." The plan was to allocate state capital toward strategic industries and reduce direct intervention within SOEs' day-to-day operations, thereby improving efficiency. The government also stated that it would

strengthen SOE corporate governance but made clear that it viewed Communist Party supervision as critically important.

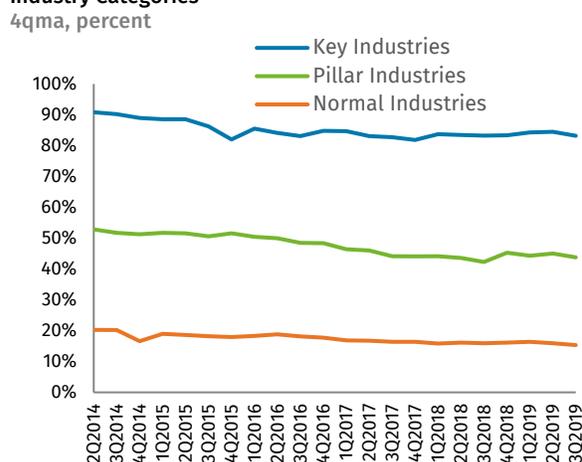
- Since 2017, the government has pushed to "corporatize" SOEs, including establishing boards of directors to replicate the structures of other commercial entities. But it also required all SOEs to institutionalize the role of Communist Party committees into their articles of association and give the Party oversight for all strategic decisions. As a result, boards of directors still lack de facto authority to manage SOE operations.

Methodology

We use China's own classification scheme to assess SOE reform progress. When information is available for listed companies, we gauge SOE revenue relative to all revenue in three clusters: (1) key industries (defense, electricity, oil & gas, telecom, coal, shipping, aviation, and rail); (2) pillar industries (autos, chemicals, construction, electronics, equipment manufacturing, nonferrous metals, prospecting, steel, and technology); and (3) normal industries (tourism, real estate, general manufacturing, agriculture, pharmaceuticals, investment, professional services, and general trade). As SOE reforms are implemented, the state firms' share of revenue should at a minimum decline in normal industries – those that Beijing has identified as suitable to market competition as the decisive factor. To supplement this primary indicator, we look at the share of all industrial assets held by SOEs, leverage ratios at state versus private firms, SOE versus private returns on assets, SOE versus private ability to cover interest payments, and the SOE share of urban employment.

Quarterly Assessment and Outlook

Primary Indicator: Share of SOE Revenues in Different Industry Categories



Source: Bloomberg, Rhodium Group.

- We upgrade our assessment slightly because state firms accounted for a smaller share of listed firms’ revenue and industrial firms’ assets this quarter.
- However, the change was driven by better performance among private firms and a one-off reclassification of assets to reflect mixed ownership changes over the past few years. The overall pace of reform remains much slower than that in the early 2000s, and improvement seen this quarter is not sustainable.
- Policy developments remain conflicting. Beijing ordered state-owned enterprises (SOEs) to adopt additional commercial objectives but tightened Party control over them, while promising the private sector a fairer competitive environment.

This Quarter’s numbers

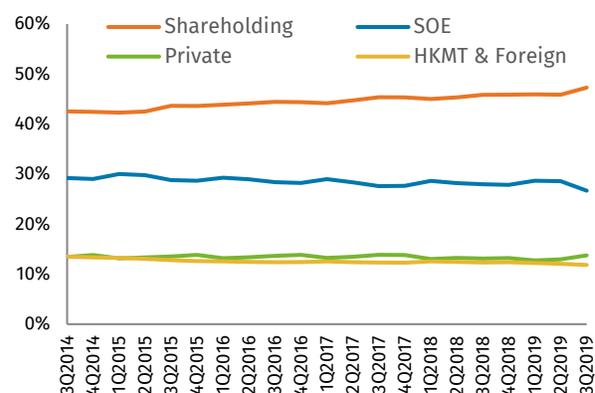
State presence in the economy as measured by the share of listed company revenue shrank slightly this quarter as state firms saw slower income growth than private firms. Among listed firms, the SOE share of revenue declined not only in “normal” industries that Beijing identified as non-strategic and pledged to withdraw state influence but also in “pillar” and “key” industries considered strategic to China’s economic development and national security. As of 3Q2019, SOE revenue shares in normal, pillar, and key industries fell to 15.3%, 43.8%, and 83.2%, respectively, from 15.9%, 45.0%, and 84.5% in 2Q2019.

Private firms in the industrial sector also saw improved profitability. Returns on private company assets rose to 7.3% in 3Q2019 from 6.8% in 2Q2019, while those of SOEs continued to deteriorate to 3.6% in 3Q2019 from 3.9% in 2Q2019 (see **SOE Return on Assets**). Similarly, private firm capacity to service debt improved, shown by an increase in firms’ interest coverage ratio to 7.9 in 3Q2019 from 7.7 in 2Q2019, while SOEs’ interest coverage ratio dropped to 4.0 in 3Q2019 from 4.3 in 2Q2019 (see **SOE Interest Coverage Ratio**). In other words, Beijing’s efforts to improve SOE efficiency have not succeeded.

Not only did private firms outperform state firms this quarter – their slice of China’s economy also expanded. Official data show a significant uptick in private firm asset growth in August (13.1% year-on-year, from 5.2% in July) and a corresponding decline of SOE asset growth (–2.6% in August from 5.6% in July). As a result, private assets accounted for 13.8% of total industrial assets in 3Q2019, up from 13.0% in 2Q2019, while the SOE asset share decreased to 26.7% in 3Q2019 from 28.6% in 2Q2019 (see **Industrial Assets by Ownership**). However, the 3.7 trillion yuan (\$530 billion) decline in SOE assets from July to August is too sharp for a single month and likely reflects

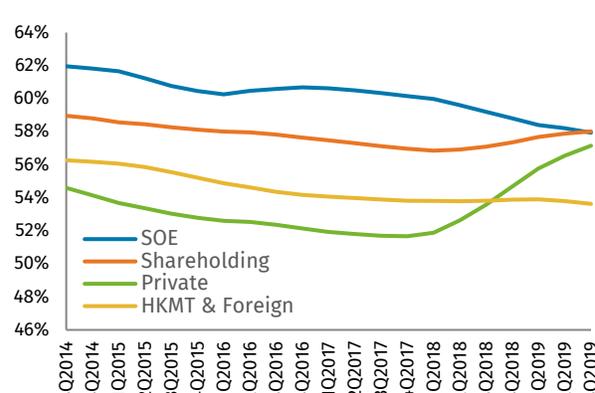
a reclassification of SOEs to private and other types of firms to account for cumulative reform efforts over the past few years, including the latest mixed ownership reforms (see **Fall 2019 Edition**). If so, that means the share of SOE assets has only decreased by 3% in five years – much slower than the 4% *per year* in the early 2000s – despite enormous progress claimed by officials.

Supplemental 1: Industrial Assets by Ownership Percent



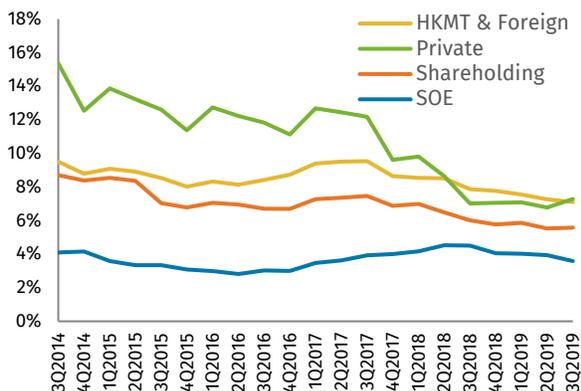
Source: National Bureau of Statistics, Rhodium Group.

Supplemental 2: SOE Leverage 12mma, percent



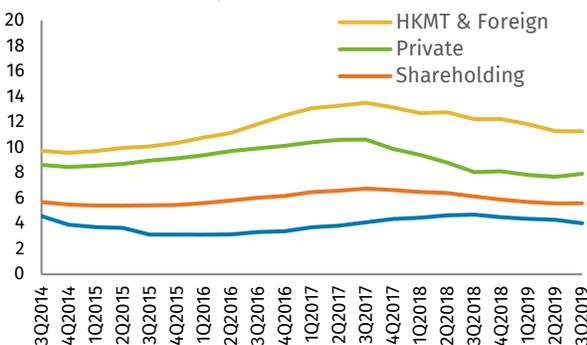
Source: National Bureau of Statistics, Rhodium Group.

Supplemental 3: Return on Assets
Percent



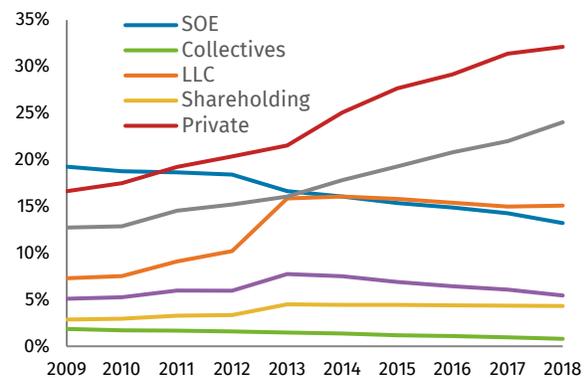
Source: National Bureau of Statistics, Rhodium Group.

Supplemental 4: SOE Interest Coverage Ratio
Profit to interest ratio, 12mma



Source: Bloomberg, Rhodium Group.

Supplemental 5: SOE Share of Employment
Percent



Source: Ministry of Human Resources and Social Security, Rhodium Group.

Policy Analysis

Recent policies offer conflicting signals: Beijing again ordered SOEs to adopt additional commercial objectives but tightened control over their operations at the same time. At a November meeting of the SOE reform small leading group, Vice Premier Liu He announced the development of a three-year action plan (2020–2022) to

improve SOE productivity, strengthen innovation capacity, tighten budget constraints, reduce subsidies, and increase returns on state capital through measures like mixed ownership reform. In December, the State-Owned Assets Supervision and Administration Commission (SASAC) added improved profit margins, lower leverage ratios, and strong research and development (R&D) expenditures into performance evaluations for central SOE leaders. These efforts suggest that Beijing is focused on making SOEs financially sustainable.

But these measures appear no different from those pursued in previous years, which as our indicators show have only delivered minimal and in some cases negative results. The lack of progress is at least partially due to tighter control over SOEs under the anti-corruption campaign (see **Summer 2019 Edition**) and Party-building initiatives (see **Fall 2019 Edition**), which have limited SOE leaders' ability to react to market dynamics.

Those constraints will continue to obstruct reform, as Beijing tightened Party control over SOEs in late 2019. In November, President Xi chaired a Politburo meeting and discussed an ordinance detailing the Party's SOE work. The ordinance, which was publicly released on January 6, declared that the Party will continue to appoint SOE leaders (a decades-long practice), review "important" proposals before the board of directors (codified in SOE governance since 2017, with significant room for each SOE Party cell to decide what constitutes "important"), and appoint a dedicated person to oversee SOE Party building (in practice since early 2017). More importantly, while stressing that the Party cells should focus on political matters, the ordinance requires Party building to be "deeply integrated" with SOE production and operation and evaluated against SOE "reform and development progress." These objectives are not clearly defined but likely indicate SOE compliance with central policies, including the newly added commercial objectives.

Even as state firms see more political control, Beijing is assuring private firms that the government will provide a fair competitive environment for all. The State Council laid out its private sector support plan in December. In addition to promising more market access and cleaning up unfair policies, the State Council urged government bodies and SOEs to speed up the processing of accounts payable to private firms, which totaled 890 billion yuan (\$130 billion) at the end of 2019 according to the Ministry of Industry and Information Technology. From private firms' perspective, these delayed payments are worse than formal trade credits to SOEs because they are usually non-interest bearing and subject to renegotiation and uncertainty between parties. The plan also commits to

improving legal protections for private enterprises, entrepreneurs, and their properties. To realize these promises, the State Council emphasized that officials in breach of contracts with private firms will be punished and the government will need to compensate private firms for any losses according to relevant laws.

These enforcement commitments do look serious and feasible, as the Party is increasingly active in disciplining government bodies and SOEs. The announced restructuring of oil and gas SOEs to improve market access for private firms in December is an illustrative test case for evaluating recent efforts. But hitting these narrow objectives does not necessarily lead to a fairer competitive environment when the Party or the government still retains ultimate power to favor certain firms over others. More needs to be done to demonstrate that private and foreign firms will be treated equally with SOEs.

Trade

The Story So Far

China is the world's largest trader, and trade liberalization played a key role in its post-1978 economic success. Despite a history of reform, China runs a persistent trade surplus shaped by residual and newly created forms of protectionism, undermining trade relations abroad and consumer welfare at home. To sustain its growth potential, China needs to remove trade and investment barriers that are inefficient for its consumers and cause friction with trading partners.

- Beijing implemented multiple rounds of import tariff cuts starting in 2015 on a wide range of goods, with a focus on information technology and consumer goods. These tariff cuts reduced the normal, non-discriminatory (“most-favored nation”) simple average tariff to 7.5% in 2018 from more than 9% in 2013 and slightly reduced trade-weighted average tariffs to 4.4% in 2017 from 4.6% in 2013.
- Beijing prioritized “trade facilitation reform” (simplification, harmonization, standardization, and transparency) when it ratified the WTO Trade Facilitation Agreement (TFA) in 2015. The government formed a national committee on trade facilitation in March 2016. After piloting reforms in the Shanghai Free Trade Zone in 2015, Beijing issued several policies to transition to a “single window” system nationwide to simplify trade inspections, declarations, taxes, and other procedures. China was ranked 46th by the World Bank in “Ease of Doing Business” in 2018, a significant improvement from 78th the prior year, in part due to lower trade-processing delays and costs.
- China's leaders emphasize the importance of increasing imports to facilitate both internal and external rebalancing. To stimulate imports and consumption, Beijing tested a series of policies, starting in the Shanghai Free Trade Zone in 2015, to facilitate cross-border e-commerce trade. Key developments include gradually lifting equity caps for foreign e-commerce businesses in free trade zones and passing a new E-commerce Law in 2018, which aimed to reduce the sale of counterfeit goods and services. In January 2019, the State Council increased the scope for tax-free cross-border e-commerce imports across 22 pilot zones.
- China has expanded and sought new free trade agreements (FTAs). Since 2002, China has signed 16 FTAs with 24 countries or regions; in 2016, trade with FTA partners (including Taiwan, Hong Kong, and

Macao) constituted nearly 40% of China's total trade volume and saw import duties reduced by RMB 42.2 billion (\$6 billion) that year. Most recently, China signed FTAs with Georgia in May 2017 and with Maldives in December 2017. Beijing is currently negotiating seven other FTAs. In November 2019, China and 14 other nations concluded negotiations on the Regional Comprehensive Economic Partnership (RCEP) to reduce regional trade barriers; the pact is scheduled to be signed in 2020.

Methodology

To gauge trade openness, we assess the change in China's imports using goods and services trade openness indexes. Scores higher than 100 indicate a growing role for imports relative to gross domestic product (GDP) since 2013 (i.e., relative liberalization of these goods and services), while lower scores indicate a falling role. Supplemental gauges look at other variables in China's trade picture: current account-to-GDP ratios for goods and services, whether goods imports are consumed in China or just reexported, the services trade balance by component, exchange rates, and trade trends in overcapacity sectors.

Note: In this 2Q2019 edition, we are replacing the original Composite Trade Liberalization Index (CTLI) with an alternate indicator due to missing data.

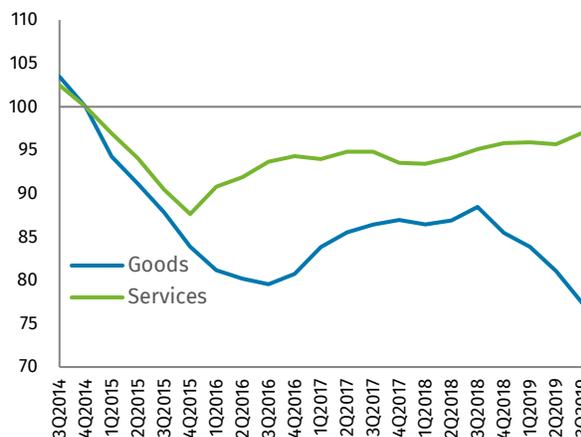
The indicator indexes the changes in the import/GDP ratios for selected goods and services relative to 2014. Our proxy line for goods trade measures ordinary trade imports—referring to imports that are not for processing, assembly, and reexport and are therefore a closer approximation of final import demand—less three types of goods: crude oil, iron ore, and integrated circuits. We exclude these goods from our ordinary trade proxy as China's imports of these goods dwarf other imports in value and are highly sensitive to external price effects in such a way that they could distort this indicator. Ordinary imports face more tariffs and other trade barriers than processing imports, for which tariffs are typically low or zero, thereby favoring export growth above import openness; improvement in China's trade regime would rebalance toward more import growth catering to final demand.

For services, we included all subsectors except tourism and transportation, which are less reform sensitive given the longer-term trend of growing outbound Chinese tourism, overseas education, and resident spending abroad. The quarterly import/GDP ratio (four-quarter rolling sum) of each category was benchmarked to 2014 to coincide with the Third Plenum in November 2013. We attempt to isolate the trade liberalization variable by

screening goods and services whose import growth is most constrained by policy, and by measuring imports over nominal GDP; ultimately, however, other factors including prices and inflation, cyclical patterns, competitiveness conditions, and global trade conditions may impact the indicator.

Quarterly Assessment and Outlook

Primary Indicator: Alternative Trade Liberalization Index
4qrs, 2014=100



Source: General Administration of Customs, State Administration of Foreign Exchange, National Bureau of Statistics, Rhodium Group.

- Our trade policy reform assessment remains neutral, as our indicators are mixed and remain impacted by tariffs.
- Tariffs drove China's imports lower and its surplus higher in 3Q2019 but also led to less dependence on reexports and stable net exports of overcapacity goods.
- Phase 1 of the U.S.-China trade deal reduced uncertainty surrounding escalating tensions between the United States and China by pausing retaliatory tariff increases with some minimal tariff rollback and provisions to strengthen intellectual property protections, curtail forced technology transfer, and improve market access in financial services and agriculture. However, it does not comprehensively resolve structural reform issues at the heart of the U.S.-China dispute.

This Quarter's Numbers

Our **Composite Trade Liberalization Index (CTLI)** is designed to look past policy changes for outcomes that reflect greater openness to imports. For the third consecutive quarter, the CTLI – which proxies goods imported into China for final consumption (excluding major commodities such as crude, iron ore, and integrated circuits) – showed final goods imports continued to decline relative to economic growth.

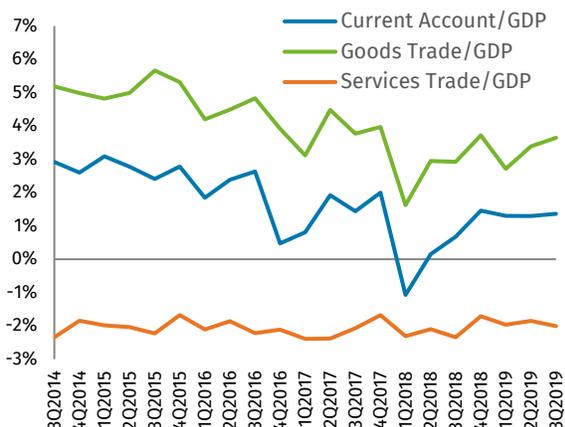
Services imports, excluding tourism, continued to expand relative to GDP in 2019, though they still remain below 2013 levels. However, **Services Trade Openness** shows in nominal terms (rather than against GDP) that China's non-tourism deficit actually shrank year-on-year for the third consecutive quarter led by falling transport service imports, likely related to weaker trade flows. Nevertheless, both imports and exports of two services categories – telecom and computer services and other commercial services – continued to increase.

The impact of tariffs obscures any clear read on trade liberalization; however, since the trade war began, China's imports have taken a hit. Relative to GDP, both China's goods surplus and services deficit expanded this quarter to 2017 levels, reaching 3.65% and 2.01% of GDP, respectively (see **External Trade**). The goods surplus rose more than the services deficit, causing the current account surplus as a whole to rise to 1.36% of GDP.

However, the same forces that drove China's external trade surplus higher drove improvement in other indicators. For one, processing trade imports, typically reflecting an export-intensive growth model, continued to fall relative to overall exports, suggesting that China's exports were less dependent on reexports (see **Structural Change in Goods Trade**). This is not just because tariffs reduced imports more than exports; processing imports were also a smaller share of total imports this quarter, compared with the same period in previous years. This dynamic also drove stabilization in **Exports of Overcapacity**. In 3Q2019, net exports of overcapacity goods remained roughly the same as in 2Q2019, relative to 2012 levels.

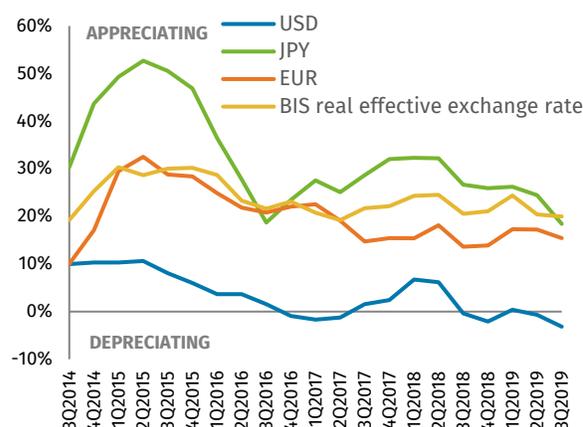
The yuan continued to depreciate against major currencies in the third quarter as uncertainty surrounding trade negotiations with Washington added downward pressure by souring the outlook (**Exchange Rate**). The move was consistent with the direction of market forces, and official data suggest the central bank did not intervene to weaken the currency further, even as export growth decelerated.

Supplemental 1: External Trade
Percent



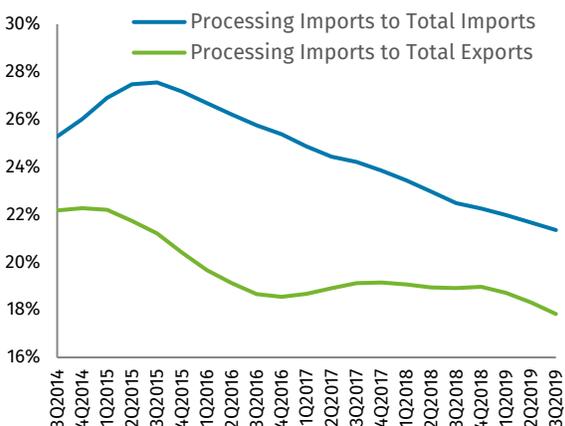
Source: State Administration for Foreign Exchange.

Supplemental 4: Exchange Rate Fluctuation
Percent



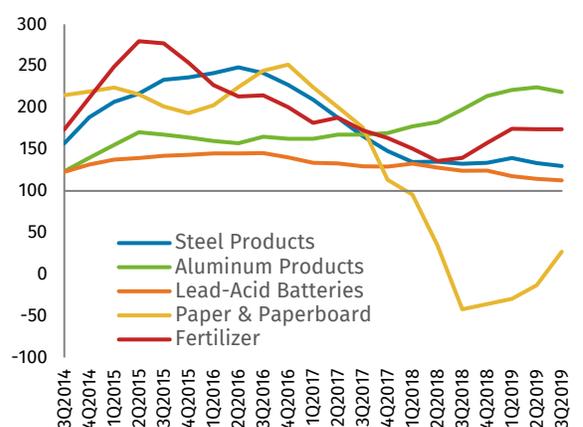
Source: People's Bank of China, National Bureau of Statistics.

Supplemental 2: Structural Change in Goods Trade
Percent



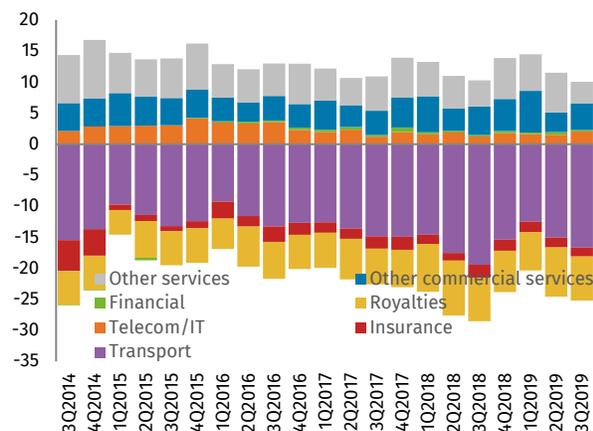
Source: General Administration of Customs.

Supplemental 5: Trade and Overcapacity
Index, 2012=100



Source: General Administration of Customs, Rhodium Group.

Supplemental 3: Services Trade Openness
USD Billion



Source State Administration of Foreign Exchange.

Policy Analysis

After nearly two years of tariffs escalation and negotiations, on January 15, 2020, the United States and China signed the Phase 1 economic and trade agreement. The deal consists of seven substantive chapters, covering intellectual property (IP) protection, tech transfer, food trade (including Chinese subsidies in these sectors), financial services market access, commitments to purchase U.S. products, macro and exchange rate management, and dispute resolution procedures. In effect, Phase 1 reduced the immediate uncertainty over possible further escalation in tariffs, achieved minor tariff rollback, and included provisions on a range of concerns but did little to resolve structural reform issues at the heart of U.S.-China tensions.

China's most concrete commitments are found in the "Chinese purchases" chapter, which outlines a managed trade program in which Beijing is to increase purchases of specified U.S. products from 2017 levels by \$77 billion in 2020 and \$123 billion in 2021 in four categories: manufacturing, agriculture, energy, and services. However, stronger U.S. imports may displace imports from other countries, casting doubt on whether the arrangement complies with international trade rules. Increased purchases of certain U.S. products could even come at the expense of other U.S. goods not subject to purchasing targets. The specificity and scale of China's purchasing targets only reinforce the state's role in managing trade, rather than letting the market play a more decisive role.

China's commitment to eliminate non-tariff measures in the agriculture and food sector is extensive. The agreement's annex details U.S. market access across many products, including beef and poultry. While agriculture market access barriers have been under discussion for years, the agreement takes many of these issues over the finish line and should promote longer-term improvement in U.S. agriculture exports to China.

Another significant outcome lies in China's IP protection commitments. While Beijing has promised to crack down on counterfeiting and piracy and improve trade secrets protections before, the deal also includes plans to monitor, publish, and evaluate implementation. More importantly, China agreed to shift the burden of proof in trade secrets theft cases to the defendant, forcing accused Chinese firms to prove they are not violating the plaintiff's IP rights, in line with its April 2019 revised Anti-unfair Competition Law. In theory, this could make IP protection less burdensome for plaintiffs, including foreign companies that have struggled to successfully defend their interests in China. Beijing also promised to increase specific IP protections in several product categories. However, doubts remain as to how this regime will work. Recent and ongoing legislative amendments enacted starting in 2019 outside the U.S.-China trade context may prove more fruitful in improving China's overall IPR regime (see **Innovation, Summer 2019 Edition**).

Besides concrete purchasing commitments, the agreement does not fully address fundamental areas of U.S.-China friction. Several provisions restate existing commitments, such as in financial services opening (see **Cross-Border Investment**). In the chapter on currency, both sides committed to not engage in "competitive devaluation." This reflects the belief that China continues to manipulate its exchange rate downward to support exports, which it is not; the central bank's recent interventions have mostly served to resist the yuan's depreciation. Other areas of

structural concern, particularly those related to industrial subsidies and the share of China's market dominated by SOEs, are largely absent from the deal.

Dispute resolution measures under the agreement include a multi-tiered consultation process. That process was formalized when the agreement came into force on February 14, 2020, with the formation of a new Bilateral Evaluation and Dispute Resolution Office to monitor China's implementation of Phase 1 commitments. Should consultation fail, the complaining side can unilaterally implement "remedial measures" or "suspend obligations under [the] Agreement," with the other party's response limited to withdrawal from the deal as an alternative to compliance.

Both sides have partially reduced tariffs. Before the Phase 1 deal was concluded, the United States dropped a planned tariff increase for December 15 and announced it would halve the 15% tariff rate on \$120 billion in Chinese goods in mid-February, but kept the 25% tariffs on imports worth \$250 billion in place. In effect, the deal slightly reduces average U.S. tariff rates on Chinese imports from 21% to 19.3%, versus only 3% in January 2018, according to the [Peterson Institute](#). On February 5, 2020, China's Ministry of Finance announced that Chinese tariff rates for \$75 billion of U.S. goods imports including crude oil and soybeans would be halved, which would facilitate increased purchases under Phase 1 commitments.

The prospects of a Phase 2 deal are not strong, as the challenging structural issues omitted so far grow more difficult by the month. With respect to timing, President Trump has made conflicting statements, indicating that negotiations would not begin until after the next U.S. presidential election and also claiming that they would begin following the Phase 1 signing ceremony. In January, China's lead negotiator Premier Liu He told state media that China was in no rush to start Phase 2 negotiations.

Meanwhile, the unanticipated novel coronavirus that spread from Wuhan in late 2019 has so severely depressed Chinese economic activity that the import targets will be very difficult to achieve. Projections of 1Q2020 headline GDP growth have been marked down significantly and are still falling. Price effects from weaker demand alone on many products slated for higher U.S. exports will also reduce the value of flows this year. With Chinese leadership focused on curtailing the spread of the virus, attending to the needs of its citizens, and taking measures to stabilize the economy, other areas of reform implementation may also suffer.