Asia Society POLICY INSTITUTE

RHODIUM GROUP

China Dashboard Spring 2020 Update

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CONTENTS

ABOUT THE TEAM:

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.

Spring 2020 China Dashboard Net Assessment

Sai Weng's Lost Horse

The COVID-19 pandemic has disrupted global governance. Beyond the health crisis, governments the world over are intervening to stabilize their economies amid the worst economic shock since the 1930s. So how are we to assess China's economic reform progress today when there are so many crosscurrents? Is yesterday's statist sin today's stabilization solution?

In decades past, and again at the November 2013 Third Plenum meeting that set out the Xi Jinping–era economic strategy, Beijing had determined that China's interests required greater economic efficiency, even if that meant relinquishing some stability. But as we have documented in this Dashboard, in recent years reforms have mostly been dialed back or put off indefinitely, particularly when pursuing reform led to disruptions. Having failed to reform is not a blessing in disguise; it has not left the Communist Party with more levers of control. Reform was needed because the levers were working less effectively over time, with growth more and more dependent on debt. Past delays limit the options for Beijing now when they are needed most, swelling unemployment and property and banking system risks.

There is an enduring hope that crises foster reform. As in the old Chinese proverb about an old man's misfortune in losing a horse leading to good outcomes, an economic morass could have the hidden benefit of leading to better policy. Sometimes crises do promote reform, but will that apply in China today? Sometimes a lost horse is, after all, just a lost horse.

Right after record low Chinese growth was reported for 1Q2020, a package of reform ideas was announced on April 9 ("Guidance on Building a Better System for Market Allocation of Factors of Production "). Then, on May 18, the eve of the "Two Sessions," the annual meeting of the National People's Congress (NPC) and the Chinese People's Political Consultative Conference (CPPCC), a much more comprehensive reform decree ("Guidance on Speeding Up the Improvement of the Socialist Market Economic System in the New Era") was jointly issued by the Chinese Communist Party (CCP) Central Committee and the State Council (top party and government leadership bodies, respectively). The May 18 *Guidance* is clearly meant to be read as a bold reaffirmation of market reform intentions. The question of whether economic pressure will compel Beijing to revert to a reform message is settled: it has. The debate as to whether there is enough new in the May 18 *Guidance*, and whether the announced reforms will actually be implemented when so many past efforts faltered, now begins.

Impact of COVID-19 and Beijing's Response in Reform Context

China's economy shrank 6.8% year-on-year (yoy) in the first quarter of 2020—its first negative rate in the post-1978 reform period—as lockdowns were extended to control the spread of the coronavirus. China's industrial economy was hit harder than its services sector (−9.6% yoy versus 5.2% yoy), as migration restrictions kept laborers home for Chinese New Year holidays and manufacturing came to a halt. In March, China began restarting its economy; by April, many people were back to work. But recovery has been uneven and slowed by falling demand in the rest of the world. Industrial production restarted but household consumption lagged.

Across our Dashboard, we observe Beijing's response to the virus reinforcing the role of the state in the economy. Inefficient state support is convenient for near-term responses but can deplete longer-term prospects because it uses resources poorly and can prevent adjustment. In this edition, we see that state-owned enterprises (SOEs) were central to China's response to the virus outbreak, building new hospitals in short order, maintaining critical supply chains, and supporting some employment while the private sector shut down. In the fiscal realm, city and local officials worked with central authorities and local businesses to provide vouchers to spur consumption in many big cities. Beijing compelled banks not to foreclose on delinquent borrowers.

Given the severity of the downturn, and Beijing's accolades for the "gold standard" of stimulus in 2008–2009, almost everyone thought they knew what to expect from the Chinese playbook in 2020—another world-leading stimulus package. But that was not in the cards. Having quadrupled its banking system in a mere decade and ballooned debt service to persistently double the value of marginal GDP expansion, Beijing couldn't do it again. So what is the alternative?

Green Shoots for Reform

During the final quarter of 2019, the period for data analysis for this edition of the China Dashboard, reform was stalled or backsliding in most areas. The state's role in the economy got bigger: listed **SOEs** accounted for a greater share of assets not only in industries central to Beijing's strategic objectives but even in normal commercial industries where Beijing pledged to wind down state presence. The **financial system** was less efficient: investment in China produced less growth than ever before in our records. Two-way **cross-border investment** flows continued to fall relative to GDP and remained below 2014 levels, demonstrating that China's revealed openness to foreign capital has not improved. **Labor** conditions deteriorated in 4Q2019, even prior to the COVID-19 outbreak, with urban wage growth falling to its lowest level and unemployment increasing. While the subnational **fiscal affairs** picture improved at the end of 2019, this was fragile, as proven by the collapse of local government revenue in 2020, making the stabilization response to the virus vastly harder.

Predictably, the erosion of growth caused by the virus has now compelled fresh talk of reform. The first serious indications of marketization since the 2013 Third Plenum meetings are now in the air. On April 9, 2020, the Communist Party and State Council jointly released a *Guidance* on improving market mechanisms to allocate production factors. At a time when the world was expecting Beijing to roll out big stimulus measures, the publication of this *Guidance* demonstrated Beijing's effort to send a pro-reform signal, implicitly acknowledging the limitations of a monetary and fiscal stimulus.

The April *Guidance*, centered on new "market allocation of factors of production" efforts, was only a warmup for a more comprehensive plan to come on May 18. The CCP's Central Committee and government State Council jointly issued "Guidance on Speeding Up the Improvement of the Socialist Market Economy in the New Era," a broad-spectrum reform manifesto covering the whole system. This is the type of document prepared for plenum meetings, not the lead-up to the National People's Congress. The *Guidance* specifically refers to the 19th Party Congress and last year's Fourth Plenum, given that China didn't have a Third Plenum on economic topics this political cycle. (The April and May documents may have been prepared for that purpose but not used until the right time.) Before turning to some of the details, consider that the long list of critical reform needs identified in this 2020 *Guidance* plan is very similar to the 2013 Third Plenum Decisions plan. This is an admission that the reform work promised for the 2013–2020 period failed to happen, as evidenced by this Dashboard. Xi Jinping had declared in 2013 that without this reform work, China would find itself in a dead end.

The May 18 *Guidance* embraces the "market allocation of factors of production" emphasized in April, as a big part of the reform plan, formalizing its entry into China's political lexicon. On overall macroeconomic policy, the *Guidance* elevates "employment-first" policy to the level of traditional fiscal and monetary policy tools for managing the economy, reflecting concern about coronavirus income impacts. Monetary and fiscal policy objectives were not altered, reiterating Third Plenum goals of clarifying local-central fiscal responsibilities and establishing a "modern central bank system," an acknowledgment of poor reform progress in those areas since 2013. Many of the long-standing imperatives we have tracked since 2013—such as increasing the share of direct over indirect taxes—are reiterated.

Competition is a focus. The *Guidance* calls for better protection for private business legal rights, improved IP and trade secrets protection (aligned with the U.S.-China Phase One agreement), formalizing the national investment "negative list" system, enforcement to dismantle illegal market entry barriers, and better competition review mechanisms. There are many pronouncements about strengthening market pricing mechanisms, and vows to make industrial policy more "functional" and "universal" and otherwise more compatible with market competition. Judicial reform is discussed, including formalizing property rights, restricting administrative interference in market activities, and establishing "checks-and-balances" in market administration. But for all these things, which have been marked as crucial for years, there is still no clarity on how they are to be done.

The SOE reform plan is not materially different from the Third Plenum plan, with a focus on separating capital management from business management at state firms and reiterating that SOEs will advance in some parts of the economy and retreat in others. The *Guidance* acknowledges that private enterprises are under enormous pressure and promises that their role in the economy will not be diminished. But it does not explain how the state sector will remain stable, the private sector will not diminish, and efficiency and sustainability will be achieved all at the same time.

SOEs will also allocate more dividends to social security—an old reform goal—to patch the giant holes in the social safety net revealed by the virus. Other measures to shore up social security include improving unemployment insurance schemes, improving the national public health emergency management system, building a sustainable healthcare and pension system, and establishing a national pension account immediately.

On the external side, the Belt and Road Initiative (BRI) and free trade zones (FTZs) retain top billing as channels for expanding economic interactions with the world. **Trade** reform is geared toward increasing the domestic value-added in exports (one of our Dashboard metrics used to gauge trade reform progress since 2013). "Opening up" remains the top-level external stance. For investment, that means the negative list will be the only restriction for inbound foreign direct investment (FDI), while the "quality" of outbound FDI must be upgraded. There is nothing new about that.

The View from Abroad

The May *Guidance* marks the clearest call for economic reform since 2013 and should be considered a watershed, not a new reason for cynicism. The central government concedes that financial stimulus ammunition is running out, and structural reform has to be the engine of new growth. Beijing also acknowledges failures in implementing reform over the past eight years—not just in light of COVID-19 setbacks but also in terms of not fulfilling its own reform agenda.

There are challenges ahead. The refusal to accept hard choices, which made 2013 vintage reforms impossible, is still starkly evident, and as yet there is no clarity on what will be shut down to make room for winners. The amalgam of political campaigns, doctrine, old promises, and other deadwood continue to overburden the document. But the introduction of this framework out of the plenum cycle, on the eve of the NPC, makes clear to us that Beijing understands how essential a credible reform agenda is to legions of businesspeople and investors inside and outside China, and that it needs to demonstrate urgency and seriousness.

But will it work? Will this document mark a turn in the story line, with observers concluding—as they did for a while after 2013—that a bolder plan to promote convergence and engagement with the OECD is underway? As we have concluded before, Beijing can substantiate its commitment to reform in many ways: for example, privatization or the breakup of state-owned firms, abolition of remaining joint venture requirements and foreign equity limits, or opening virtually all industries to FDI across the board (save for a dozen or so exceptions, as in the OECD). Structural proof of reform such as the outcomes suggested here will take some time, and the sour sentiment swirling around China today will not turn sweet overnight, even if Beijing takes a liberal turn.

Observers are looking to the annual (but delayed this year) Two Sessions for signals of Beijing's reform seriousness. Our initial read from the NPC is that Beijing showed restraint by not opting for a bazooka-style fiscal or monetary response, and by dropping the GDP growth target for the first time since 1994. In theory, this should mean policy focuses on employment and price stability instead of headline growth. The break with a growth target and the paucity of stimulus make the interpretation of reform documents from April 9 and May 18 more positive.

Overshadowing the interesting economic policy dynamics here was the bolt from the blue: end-running any legal process to impose a national security law on Hong Kong. This has accelerated downward pressure on a U.S.-China relationship already falling fast, with Secretary of State Mike Pompeo calling for the end of Hong Kong's treatment as autonomous from China. As a result, the political costs of any economic engagement with China by U.S. companies or investors have increased. Beijing's shift on Hong Kong undermines any reform signal from China, reducing incentives to invest in China via Hong Kong and threatening the Chinese currency's stability.

China now faces its greatest economic test in decades. Will China grasp this opportunity to reorient the economy to sustain long-term growth through marketization? Or will we see a repeat of the failures after 2013, when many promised reforms were sacrificed for fear of the instability and change that reform requires?

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

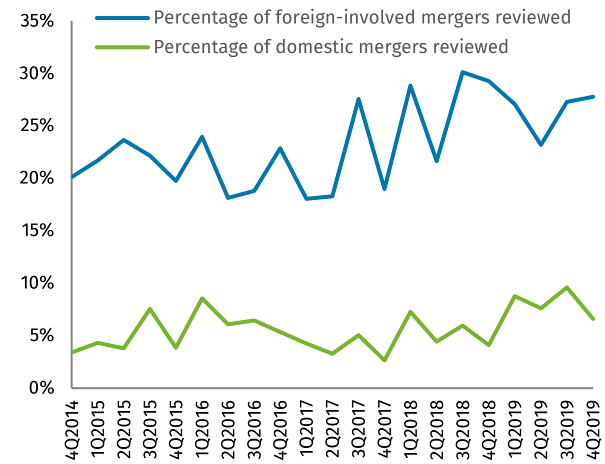
- We maintain our neutral assessment of competition policy reform. Data and policy developments sent mixed signals in 4Q2019.
- China's market regulator continued to strengthen antitrust enforcement but disproportionally targeted foreign-involved mergers. Market entry barriers for small businesses increased, but exit barriers for formally registered companies have fallen.
- Beijing vowed again to improve China's competition environment. While the focus on reform is encouraging, thus far specific measures do not appear promising given unfair enforcement in the past.

This Quarter's Numbers

Beijing stepped up antitrust enforcement but focused disproportionally on foreign firms. In 4Q2019, the State Administration for Market Regulation (SAMR) reviewed 53 foreign-involved mergers and 46 domestic ones, up from 51 and 43 in 3Q2019, respectively. That means 28% of foreign-involved merger deals were reviewed, slightly up from 27% in 3Q2019. But for domestic firms, that percentage fell from 10% to 7%, even as domestic mergers increased by 56% (250 more deals) from 3Q2019 to 4Q2019. In other words, the asymmetric treatment of foreign and domestic firms worsened in 4Q2019.

Primary Indicator: Merger Reviews

Percentage



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

Foreign firms reduced new activity in China in the fourth quarter, suggesting they may be losing confidence in China's reform outlook. Foreign firms announced only 2% (or just 4) more mergers this quarter. Since 2016, the number of foreign-involved deals has consistently declined while domestic deals climbed. The COVID-19 outbreak will likely accelerate these trends in 2020.

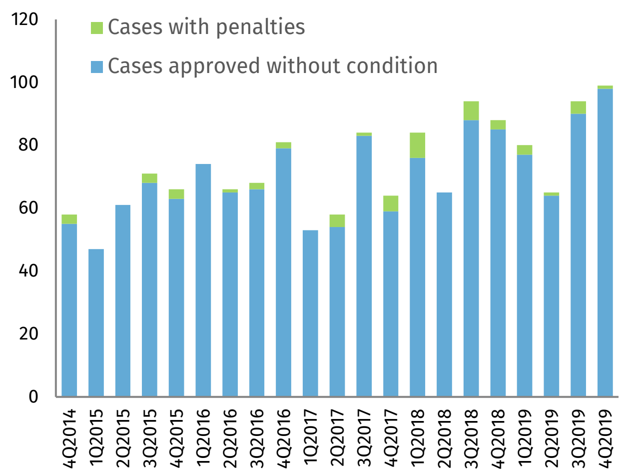
China's judicial system remains opaque for businesses to protect their interests. The Supreme Court announced that it received more than 420,000 competition-related cases in 2019, a 41% increase from 2018. But its website only published 23,472 cases, 25% more than last quarter but much lower than the rise in new cases (see **Judicial System Transparency**). Foreign complaints, such as the U.S. Special 301 Report released in April 2020, are increasingly focused on these rule of law concerns.

Despite Beijing's repeated emphasis on supporting small businesses and entrepreneurship, it was significantly more difficult for *getihu* (i.e., small, sole proprietorship businesses) to enter the market in 2019. According to SAMR, the number of newly registered companies increased by 10.4% (see **Market Entry and Exit**), on par with 2017–2018, but the number of *getihu* dropped by 2.8%, compared with 12.3% growth in 2018. The retreat of *getihu* is likely related to the difficulties for informal businesses to access funding amid slowing growth and tight credit—conditions that will worsen in 2020.

At the same time, companies had less difficulty exiting the market. SAMR reported that 38.6 million companies were in the market at the end of 2019 (up 11.1% from 2018). One-fifth of those (7.4 million) were newly registered and 3.6 million were dissolved, up 55% from 2018. Given that economic conditions in 2019 were similar to those in 2018, the increase is likely due to better dissolution procedures than to a more adverse business environment. Indeed, SAMR reported that 1.3 million companies (36%) were dissolved via simplified procedures, significantly up from 0.5 million (20%) between March 2017 (when the simplified procedures were enacted) and February 2018. This outcome validates the World Bank's move to upgrade China's ease of doing business rating (ironically, in as much as we are talking about how easy it is to shut down!).

Supplemental 1: Results of Merger Reviews

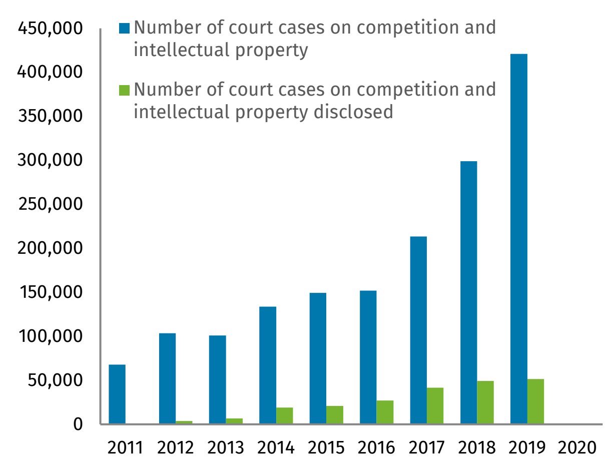
Number of cases



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

Supplemental 2: Judicial System Transparency

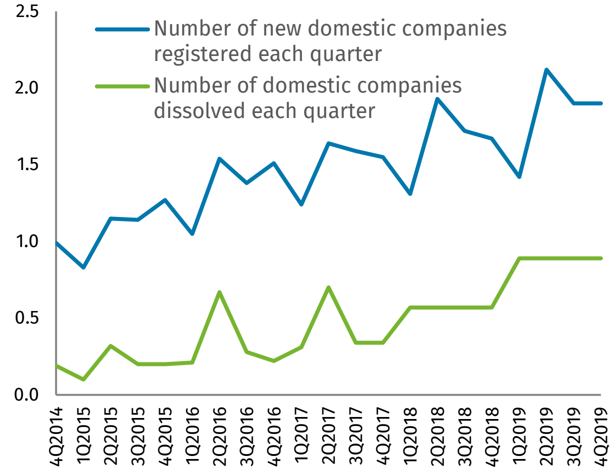
Number of court cases



Source: Judgements Online, Supreme Court.

Supplemental 3: Market Entry and Exit

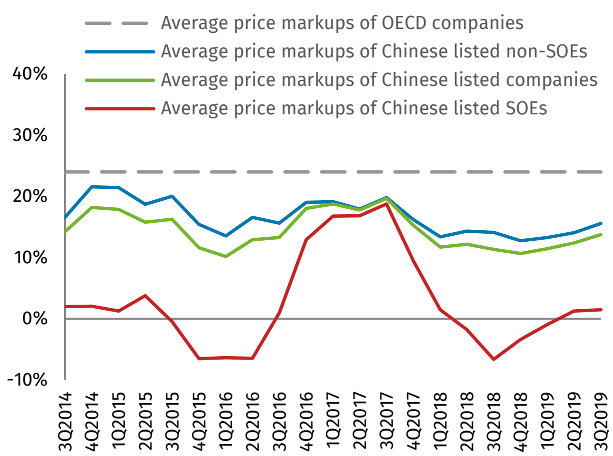
Millions



Source: State Administration for Market Regulation, Rhodium Group.

Supplemental 4: Pricing Power Index

Percentage



Source: Bloomberg, Rhodium Group.

Policy Analysis

Beijing vowed to improve China's competition environment in recent months. On April 9, 2020, the Communist Party and the State Council jointly released an opinion on improving market mechanisms to allocate production factors. This is the most comprehensive document since the 2013 Third Plenum on the role of the market and competition policy.

The opinion repeated long-standing admonitions to "strengthen the foundation of competition policy, break local protectionism, clean up anti-competitive rules, further reduce the role of government in the direct allocation of production factors, and treat all firms equally." Little progress has been made on any of these fronts in recent years, and details in the new opinion are too scant to tell whether this time will prove to be any different. But it is notable that Beijing is emphasizing the centrality of market-oriented, pro-competitive reform as a necessary response to the COVID-19 economic calamity – this is a reversion we have anticipated.

The opinion also discussed three elements of market pricing reform. First, Beijing committed to "establish a mechanism to benchmark civil servants' salaries to those of company employees." This implies civil servants' salaries will be allowed to fluctuate with the market to incentivize officials to work hard. Beijing also pledged to raise civil servants' salaries to attract more talent. The changes show an ambition to introduce market mechanisms into the government, rather than withdrawing government from the market. It is not clear to us that salary structures for predictable public sector work *should* mirror those of commercial endeavor risk taking.

Second, the opinion proposes to change the government's role in pricing mechanisms from "setting specific price levels to setting pricing rules." Only seven types of prices are set by the central government in China (according to the updated March 2020 "Central Pricing Catalog"): electricity distribution; oil and gas distribution; rail, port, and air transportation; water supply; postage; bank charges; and some pharmaceuticals. The inclusion of "oil and gas distribution" marks a change from the 2015 catalog, from pricing oil and gas to pricing distribution. This change implies Beijing will liberalize oil and gas prices while controlling distribution markups (similar to electricity prices), enabled by the December 2019 separation of pipeline businesses from national oil companies.

Last, the opinion promised to strengthen antitrust enforcement on market pricing, which is critical to the prevention of abuse of market power once prices are liberalized. However, we do not expect much progress here. Just as increased merger review authority has not been applied even-handedly (recall that foreign firms are targeted disproportionately), more power on pricing does not assure a fair outcome. To overcome limited manpower at the central level, Beijing authorized local governments to enforce antitrust rules (see **Summer 2019 edition**). But local governments are far more likely to protect local champions given their contributions to local tax revenue and employment stability. That is why, worldwide, competition policy authorities tend to be centralized, not devolved locally.

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

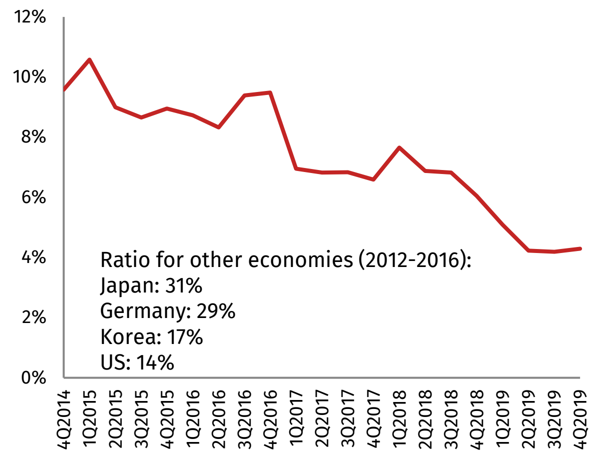
- Our assessment of cross-border investment liberalization remains negative for 4Q2019. Most indicators of China's openness to capital flows showed no improvement.
- Overall capital flows picked up in 4Q2019, but portfolio inflows moderated despite efforts to promote them. Relative to the size of China's economy, cross-border finance remains diminished compared to the beginning of the Xi Jinping era.
- Beijing encouraged foreign inflows but continued to limit outbound investment, and domestic economic concerns make that unlikely to change. In spring 2020, concerned about the impact of COVID-19 on investor expectations, Beijing lifted quotas on some portfolio inflows.

This Quarter's Numbers

China's openness to cross-border capital flows has not improved meaningfully. We saw the first uptick in **External Financial Liberalization** since 1Q2018, but mostly from typical year-end effects when foreign direct investment (FDI) transactions are recognized. Compared to the United States, with gross cross-border capital flows equal to 14% of GDP—or Germany (29%) and Japan (31%)—China has two-way flows amounting to little more than 4% of GDP, down from 9% in 2014.

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.

Households and corporates continue to move savings outside China, where returns are higher. Capital outflows are revealed in the "other investment" balance, which showed net outflows of $37.4 billion in 4Q2019, and through "errors and omissions," which rose to $63.6 billion (see **Net Capital Flows**). Total errors and omissions outflows were $198 billion in 2019, larger than the whole current account surplus, totaling $141 billion. Capital controls reduced FDI outflows to around $24 billion per quarter in 2019, down considerably from 2018.

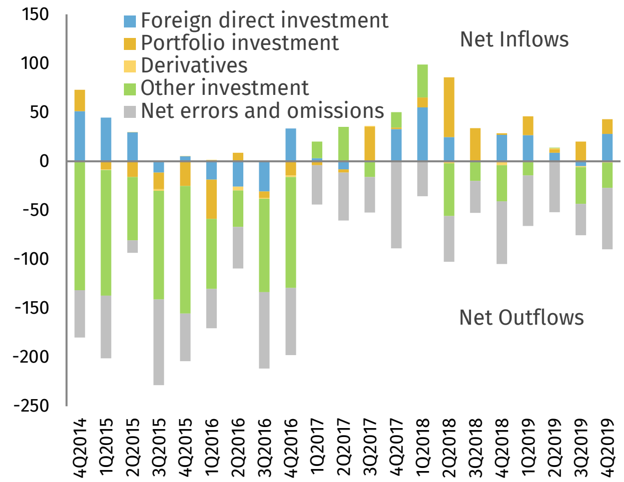
Portfolio inflows into equity and bond markets are still slow in materializing. Both inflows and outflows remained unchanged in 4Q2019 from the previous quarter. Inflows reached $41 billion in the fourth quarter, bringing full-year portfolio inflows to $147 billion—a decline from $160 billion in portfolio inflows in 2018 (see **Breakdown of Cross-Border Financial Flows**).

Foreign exchange reserves declined modestly in 2019, with Beijing intervening to avert trade war-related currency weakness (see **FX Reserves**). The central bank did not appear to change currency (RMB) management policy; instead, it sought to remain as neutral as possible amid sensitive bilateral trade negotiations with the United States. RMB internationalization remained a distant goal, with the currency used in just 1.84% of global transactions in 4Q2019, down from more than 2% (see **Currency Internationalization**). That is trivial compared to other currencies, including several issued by countries with much smaller economies than China's.

There was no growth in foreign participation in mergers and acquisitions of Chinese firms. The proportion of deals involving foreign buyers fell to 12% in 4Q2019 from 16% in 3Q2019, in line with the 2017–2019 average of 14% (see **Foreign Appetite and Market Access**).

Supplemental 1: Net Capital Flows

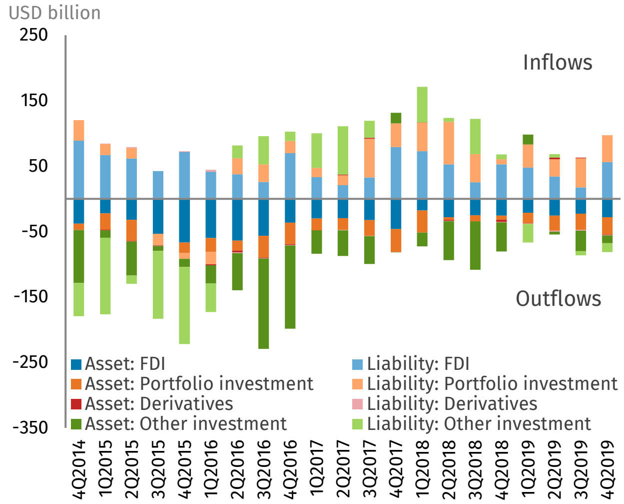
USD billion



Source: State Administration of Foreign Exchange.

Supplemental 2: Breakdown of Cross-Border Financial Flows

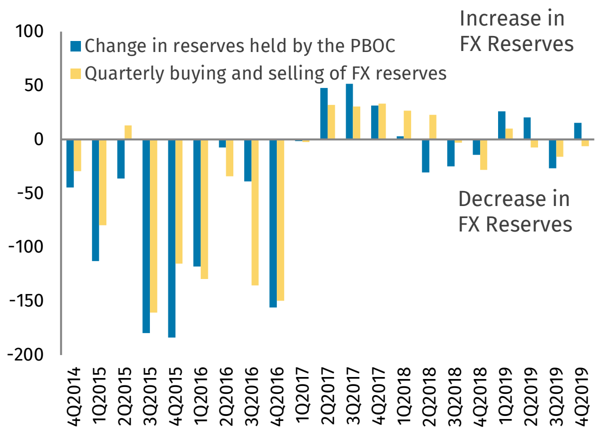
USD billion



Source: State Administration of Foreign Exchange.

Supplemental 3: Currency Intervention

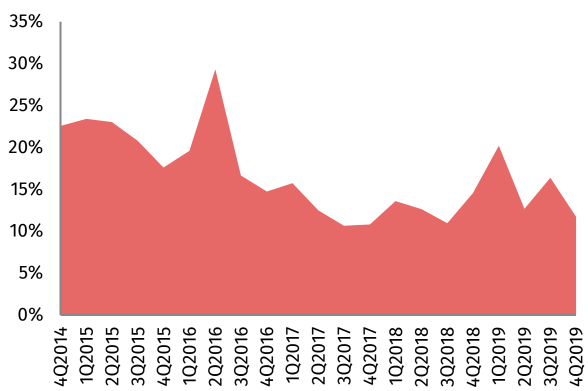
USD billion



Source: State Administration of Foreign Exchange, Rhodium Group.

Supplemental 4: Foreign Appetite and Market Access

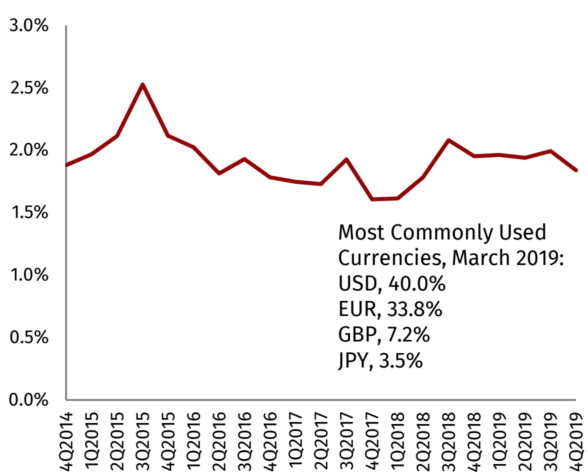
Share of deals with foreign buyers in total number of acquisitions with Chinese target, percentage



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

External forces shaped reform dynamics this quarter. The Phase One trade agreement with the United States promised equity market opening, but the COVID-19 outbreak has obscured the picture. The agreement also announced dates for previous liberalization commitments, such as removal of restrictions on foreign insurance companies by April 1, 2020, and promised faster approvals for long-standing financial services license requests (some of which have now been granted).

The COVID-19 outbreak creates new urgency to promote foreign investment, but concerns about outflows remain. In March, the Ministry of Commerce (MOFCOM) sought public comment on revisions to the Catalog on Encouraged Foreign Investment Industries, a document that guides inbound FDI. Both MOFCOM and the National Development and Reform Commission (NDRC) have pledged to "stabilize" FDI in light of the coronavirus emergency, as the outbreak is profoundly shifting the external environment for both inbound and outbound investment. Many countries are reconsidering their reliance on foreign sources of supply, particularly for critical and strategic goods, and investors in China—the biggest beneficiary of booming global FDI for three decades—are looking at supply chain diversification or even reshoring. Several Organization for Economic Co-Operation and Development (OECD) governments have tightened foreign investment screening in part to prevent opportunistic foreign investors from buying their assets at a discount as a result of COVID-19.

China continues to encourage portfolio inflows, and the Phase One deal allows U.S. firms to invest in asset management companies in the distressed debt market (at the provincial level, not nationally). After lifting restrictions on Qualified Foreign Institutional Investors (QFIIs) in late 2019, the People's Bank of China (PBOC) and State Administration for Foreign Exchange (SAFE) in May 2020 implemented regulations allowing foreign investors to engage in a wider range of onshore financial markets. The regulations simplify profit repatriation (no longer requiring a special audit report by a Chinese CPA), allow investors flexibility in choice of foreign currency, and make other technical improvements. These changes are timed to promote a better environment for portfolio inflows, showing Beijing is committed to encouraging inflows but in a controllable way.

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

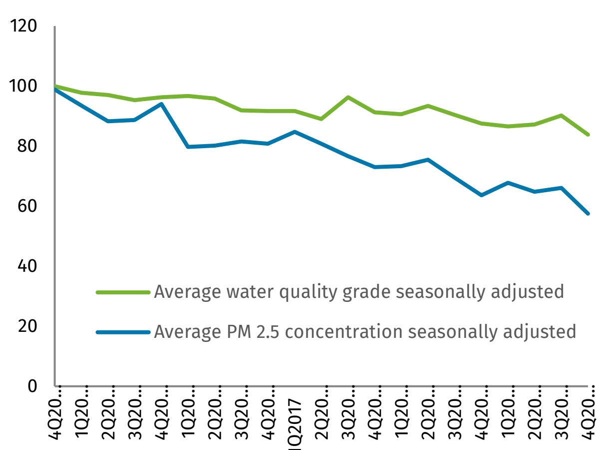
- We upgrade our environment reform assessment in 4Q2019 because air quality improved in northern cities and water quality improved in China's big river systems. The COVID-19 crisis, not reform efforts, will extend these trends with the economy stalled.
- The COVID-19 outbreak and economic shutdown have improved environmental conditions temporarily, but recession is not a policy choice—the hard work of reform still lies ahead. Past slowdowns suggest that pollution reduction will be short lived as officials focus on economic preservation for the rest of 2020.
- Renewable energy usage and efficiency increased in 2019. Yet, a broader automotive sector slowdown prevents greater adoption of new energy vehicles.

This Quarter's Numbers

China's environmental conditions improved in 4Q2019, even before COVID-19 shut industry. Cities in air pollution control zones saw the most improvement (see **Environmental Impacts**). Air quality in the 11 cities we track in northeastern Hebei province (part of the Beijing-Tianjin-Hebei region where pollution reduction is prioritized) improved with average PM 2.5 levels falling by nearly 25% quarter-on-quarter. Outside of priority zones, however, conditions deteriorated: air quality in southern activity hubs Fujian and Guangzhou declined. Production data in the second half of 2019 showed heavy industrial output of iron ore, steel products, and cement surging in central, southern, and western provinces, suggesting some relocation of industrial activities outside targeted northeastern cities in response to pollution controls.

Primary Indicator: Water and Air Quality Trends

Index, April 2013 = 100



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

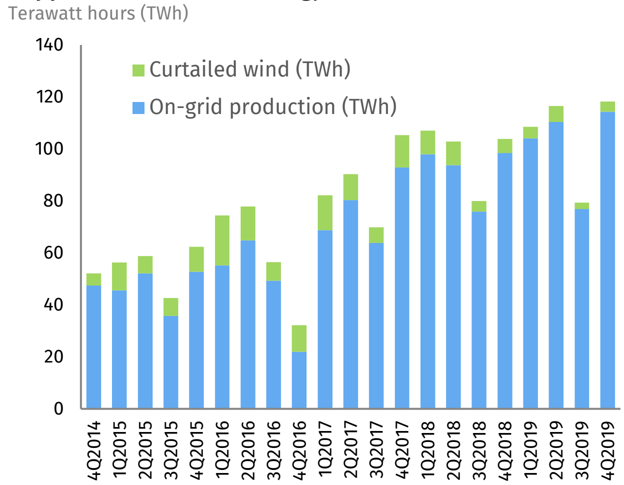
Renewable power efficiency and usage remained mostly unchanged from the previous quarter. Spilled wind—a measure of the amount of wind energy wasted because it cannot be efficiently transmitted to the power grid—decreased in 2019, suggesting measures to increase wind's contribution to the power supply are working (see **Wind Energy Curtailment**).

Replacing China's auto fleet with more environmentally friendly electric vehicles remains a key policy goal and is important for reducing pollutant emissions in the long term. However, sales of new electric vehicles (NEVs) fell in 4Q2019 due to continued phase-out of subsidies, consolidation of players in the market, and a broader downturn in the auto sector (see **Sales of NEVs**). This suggests NEV sales targets set by Beijing in 2017 will not be met by the end of the year.

The coronavirus outbreak will result in improved environmental conditions in coming quarters, but lasting changes will require sustained, intensified environmental policy development and enforcement. Even as labor migration restrictions are lifted and industrial activity resumes, travel around the country is still 70% below normal levels. Domino effects from COVID-19 will suppress external demand for Chinese manufactured imports, limiting domestic production and resulting pollution. China's official GDP contracted by 6.8% in the first quarter. Accordingly, air and water pollution—which track industrial and energy consumption trends—declined precipitously in 1Q2020. It remains to be seen whether Beijing will use this opportunity to prioritize environmental protection while recovery remains sluggish.

Supplemental 1: Wind Energy Curtailment

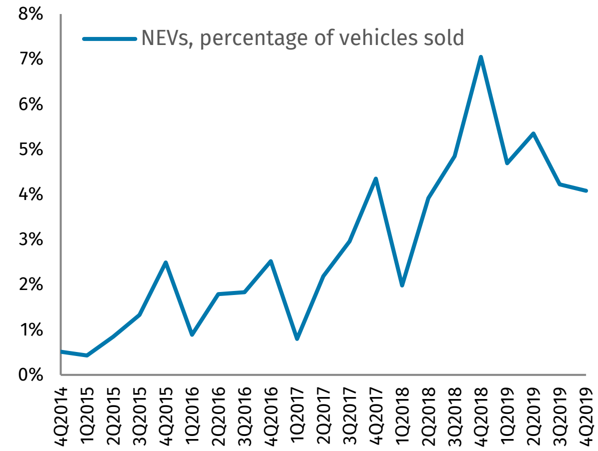
Terawatt hours (TWh)



Source: China Electricity Council, Rhodium Group.

Supplemental 2: Sale of New Energy Vehicles

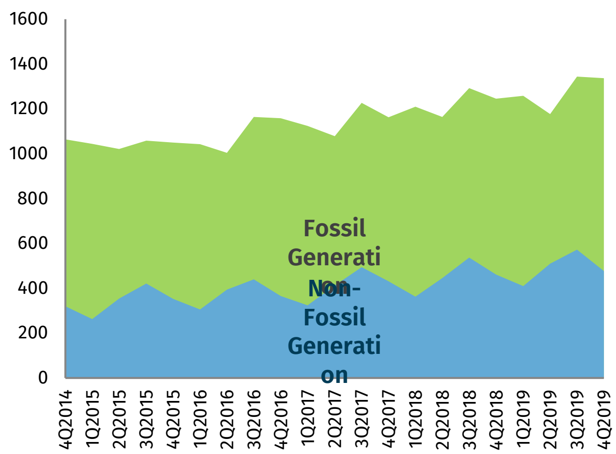
Percent



Source: China Association of Automobile Manufacturers, Rhodium Group.

Supplemental 3: Overall Electricity Generation

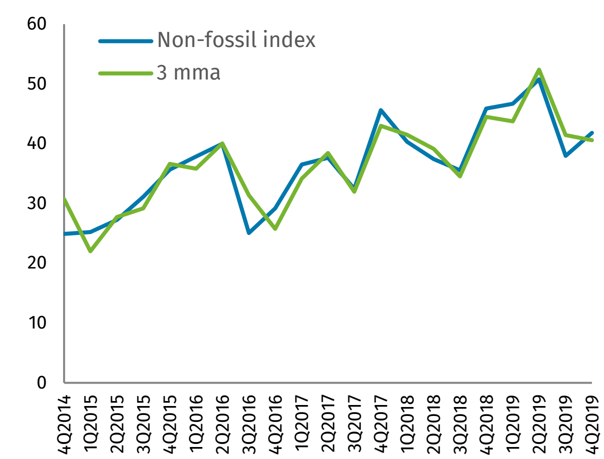
Billion Kilowatt-Hours



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

Prior to the COVID-19 outbreak, policymakers were focused on meeting long-standing 2020 domestic goals, including new targets for renewable energy. The COVID-19 crisis has changed the priorities: first to quickly implement environmental control measures like water monitoring to help contain the virus, and then to balance enforcement with the need to stimulate economic activity. While the reduction in industrial activity during the outbreak temporarily improved air quality indices, that progress will reverse when industrial production resumes. Officials typically favor growth over the environment when coming out of a recession.

Beijing's environmental policy during the review period focused on limiting the spread of COVID-19. In February, the Ministry of Ecology and Environment (MEE) issued emergency guidance to increase wastewater treatment checks to stop waterborne spread. Beijing also announced revisions to the Wildlife Protection Law that would ban the trade and consumption of wild animals, including wildlife wet markets like the Wuhan market, where experts believe COVID-19 spread early on. However, observers are skeptical: results will depend on how a final law is formulated and enforced. Wildlife trade is a big business in China, employing 14 million workers according to a 2017 study, and officials likely will be reluctant to enforce a crackdown on the industry amid weak economic conditions. The ban is also unlikely to cover the use of animals in traditional Chinese medicine, limiting the potential for major strides in wild animal conservation and ending wildlife trade.

Other signs suggest environmental enforcement may be relaxed in response to the crisis. Although the MEE asserted that environmental standards would not be relaxed during the pandemic, many recent measures appear to do just that. On March 9, the MEE reported that it would "adjust" environmental enforcement for nearly 300,000 businesses facing cash shortages by giving inspectors the option to extend compliance periods and forgo penalties for minor violations. Some firms (e.g., low-emissions firms or manufacturers of needed equipment) will be exempted from environmental inspections, and criteria for several industries have been relaxed. It is unclear when MEE assessment procedures will return to normal. Given that the coronavirus will weigh down China's economy for months if not years, authorities may extend lax enforcement, undermining reform commitments.

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

- Our financial reform assessment is neutral this quarter: financial inputs generated less economic growth, indicating the financial system was less efficient.
- Regulators are squeezing high-risk behavior out of the market by keeping up shadow banking controls and reducing the gap in funding costs for banks and riskier nonbank financial institutions.
- New credit risk is materializing, which is positive for the direction of financial reform yet highlights fragility within China's system and the difficulty policymakers will face in rolling back guarantees too quickly.

This Quarter's Numbers

China's growth remains weighed down by a financial system unable to price capital and risk efficiently. Our **Quarterly Incremental Capital Output Ratio** (QuICOR) indicator rose to 7.36 in 4Q2019 from 7.24 in the third quarter, another record. This shows that investment in China produces far less growth than in other economies. This results from reliance on state-owned enterprises (SOEs) as the backbone of the economy—firms neither created nor managed to prioritize efficiency. Most of the new credit SOEs receive merely repays interest on old debts. This was the last pre-COVID quarter: return on investment will worsen going forward.

Primary Indicator: Incremental Capital Output Ratio
4qma, ratio value

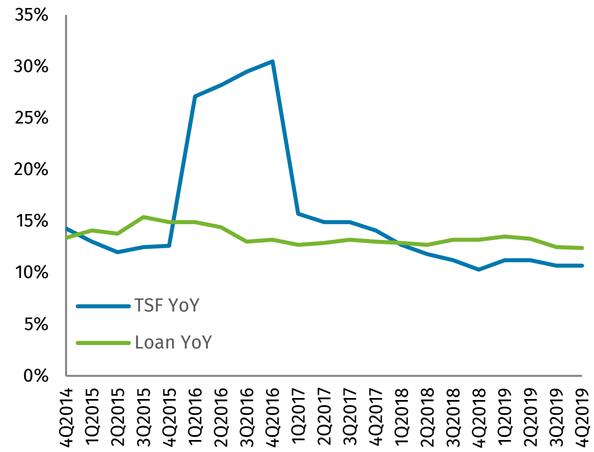
Source: International Monetary Fund, National Bureau of Statistics, Rhodium Group.

Growth in Credit remained stable in 4Q2019. Shadow banking continued contracting within China's credit data due to intensified regulation and changing risk perceptions following the failure of Baoshang Bank earlier in 2019. Credit growth has picked up so far in 2020 as borrowing rates were lowered in response to COVID-19. This is temporary: financial planners still think tighter credit policy is necessary for the long term to move beyond over-reliance on debt-fueled growth.

A significant reform indication is convergence between less regulated money market rates and more strictly policed bank deposit rates. Beijing has not liberalized deposit rates yet but has guided money market rates lower, effectively squeezing high-risk behavior out of the market. The gap between interbank funding costs for deposit-takers like banks and nonbank financial institutions was just 0.14 percentage points in 4Q2019 (see **Interbank Lending Rates**), leaving little room for arbitrage. In addition, lower Yu'e Bao deposit yields (under 2% in April 2020, down from an average 2.31% in 4Q2019) reduce opportunities for nonbank institutions to attract funding, as many banks are offering rates around 2.25% (see **Return on Savings**).

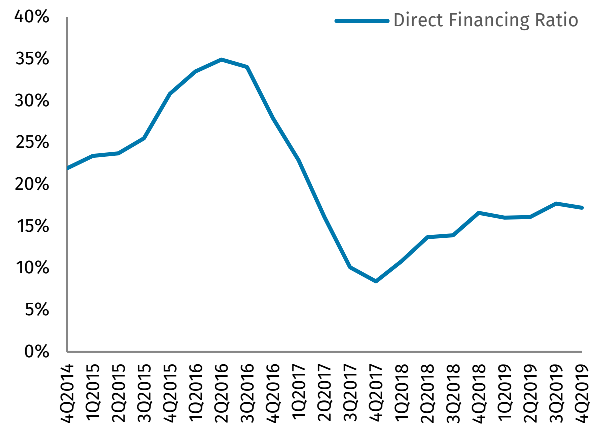
Foreign institutional investors still view China as a risky bet given capital controls and the potential for regulatory change in the event of financial stress. In gross terms, foreign ownership of China's government bonds and policy bank bonds has increased in recent years, as global indices have added China's securities into their weightings. However, the overall proportion of foreign ownership of China's bond market remains unchanged at 2.2% in 4Q2019, a low level for a financial system that aspires to be integrated into the global economy (see **Foreign Held Bonds**).

Supplemental 1: Growth in Credit
Percent



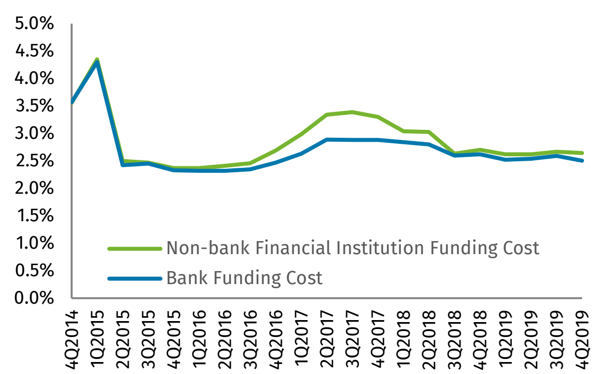
Source: People's Bank of China.

Supplemental 2: Direct Financing Ratio
4qma, percent



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

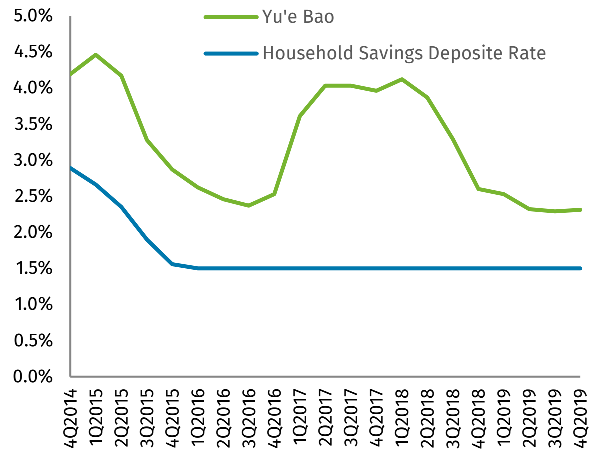
Supplemental 3: Interbank Lending Rates
Quarterly average, percent



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

Supplemental 4: Return on Savings

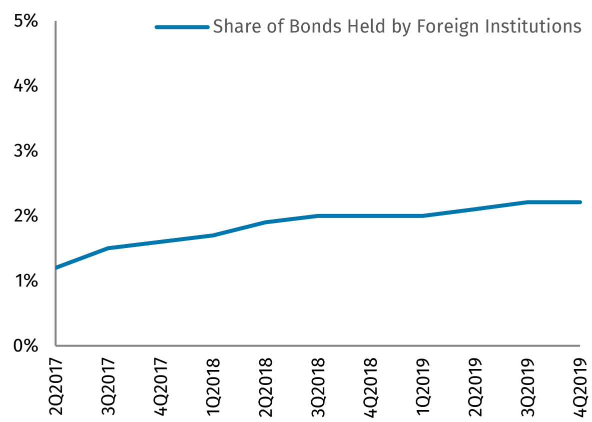
Quarterly average, percent



Source: People's Bank of China.

Supplemental 5: Foreign Held Bonds

Quarterly average, percent



Source: ChinaBond, Shanghai Clearing House, Rhodium Group.

Policy Analysis

Emergency efforts to stabilize the economy in the face of the COVID-19 pandemic have dominated the policy discussion this period. Short-term countercyclical steps do not necessarily indicate long-term directions. The challenge is to distinguish what is permanent from what will be fleeting, which is hard given that no one knows when the coronavirus crisis and its associated economic fallout will end.

Lending rates are becoming more closely tied to market rates, but deposit rate liberalization is slowing. Late in 2019, the People's Bank of China (PBOC) announced that banks would be required to price existing loans based on the new loan prime rate (LPR) as of the end of March 2020. This means lending rates will fall, as well as bank profits (so-called net interest margins). The central bank used its tools to lower bank funding rates (in China's money markets) to make that possible, so that they can pass lower costs on to borrowers without hurting bank profits too much. This new system links money market rates and corporate borrowing rates in the real economy, providing a more credible guide of true demand and supply of credit (though it ultimately depends upon rates set by the PBOC). The deposit rates paid to regular bank depositors on the other hand are unlikely to be liberalized soon.

Credit risk is increasing, as more banks face liquidity pressure given low rate incentives to work with them, and corporate bonds are defaulting in much larger numbers. Four banks were officially restructured in 2019, most notably Baoshang Bank in Inner Mongolia in May. The PBOC even used a new financial vehicle (Chengfang Huida Enterprise Management Co., or "Huida") to recapitalize one of them (the Bank of Jinzhou). In early April 2020, the Bank of Gansu in northwest China faced a sudden bank run, forcing the PBOC to announce yet another restructuring plan.

Corporate bonds are defaulting in greater numbers. Default levels are likely to exceed 3% of total maturing issues in 2020 (approaching more developed bond market levels). These are positive signs for the direction of financial reform, as they are necessary for market pricing, but they also highlight fragility within China's system and the difficulty policymakers will face in rolling back guarantees too quickly.

Opening to foreign participation continues, with a slight nudge from the U.S.-China Phase One trade deal (at least for U.S. firms). Chinese officials advanced the timeline for piecemeal financial sector liberalization with the Phase One agreement, removing some equity limits and more restrictive licensing and operating requirements for asset management (mutual fund) firms as of April 1. Several firms have applied to the China Securities Regulatory Commission to take wholly owned stakes in onshore asset management businesses, including Blackrock, Neuberger Berman, and JPMorgan.

The Phase One deal also secured foreign participation (for U.S. firms) in provincial licenses to purchase distressed debt, but this falls far short of nationwide market access. China also authorized the creation of a new national-level asset management company, Galaxy Asset Management Company, in a sign of liberalization and diversification of the distressed debt industry away from the existing four national-level players (Huarong, Cinda, Great Wall, Orient). This may create more opportunities for foreign investors in the future, but so far the steps taken are incremental and unlikely to generate much new inbound investment.

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

- We upgrade our assessment of fiscal affairs reform this quarter: local governments spent less, resulting in a smaller fiscal gap, but this will be short lived due to COVID-19.

- Local fund expenditure tied to costly land development declined. Revenue from stable, transparent sources like taxes increased modestly but will suffer in coming quarters due to the coronavirus.

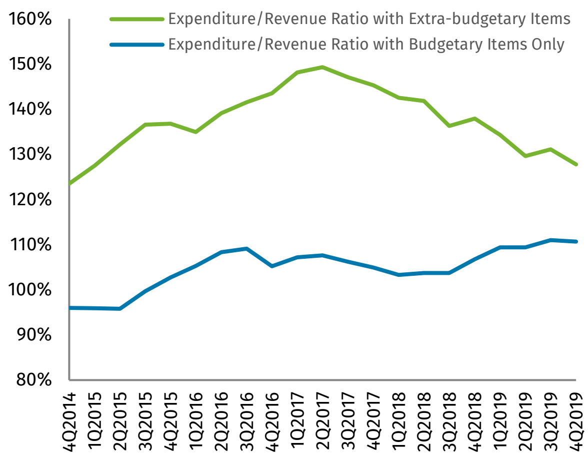
- The outbreak of COVID-19 darkens the fiscal outlook for 2020, with local tax and land revenue already falling sharply early in the year. Beijing will help bridge the revenue gap with special treasury bonds. Conditions could force localities to be more conservative with spending outside their budgets, positive for reform, but negative for growth.

This Quarter's Numbers

The fiscal gap between local governments' spending and what they take in narrowed this quarter, in line with fiscal reform objectives. The augmented **Local Expenditure-to-Revenue Ratio** narrowed to 128% in 4Q2019, the lowest in nearly four years, compared with 138% in 4Q2018. Lower expenditures in 4Q2019 drove this improvement, reversing a 15.8% increase in the third quarter.

Primary Indicator: Local Governments Expenditure-to-Revenue Ratio

4qma, percent



Source: National Bureau of Statistics, Rhodium Group.

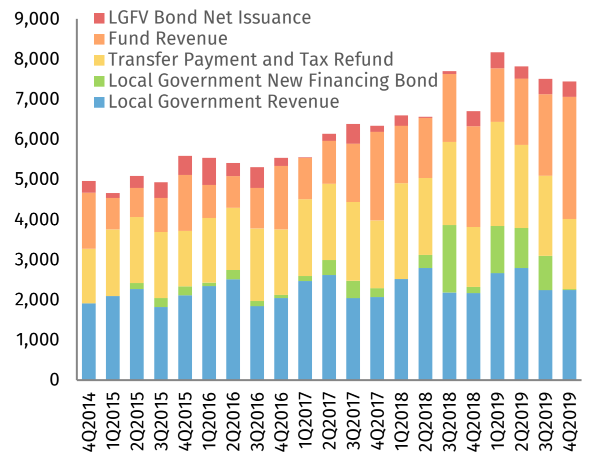
local funds spent 0.8 trillion yuan ($113 billion) *less* than their allowance for that year, which has not happened since 2015. Historically, land-related spending drives local government expenditure. Since 2019, however, the Ministry of Finance has stopped reporting land-spending data, making it impossible to see what is driving the present decline in fund expenditure.

More revenue from stable, transparent sources helped narrow local spending gaps. Both tax revenue and revenue earned by local government funds modestly improved in the fourth quarter, while central government transfers increased substantially, rising 13.8% from a 7.4% decline in the third quarter. Local bond issuance fell sharply to only 21 billion yuan in the last three months of 2019 (typical for this time of year).

Social expenditures accounted for a slightly bigger share of total spending in 4Q2019 due to increased environmental protection and social security expenditures (see **Government Social Expenditures**). In the coming quarters, we expect government social spending to increase in response to the COVID-19 outbreak, especially health-related spending. Social security expenses will also rise as governments step up payments to unemployed and low-income families impacted by the coronavirus and subsequent closure of economic activity. But in the aggregate, we do not expect that support to fully make up for faltering growth due to the coronavirus shock.

Supplemental 1: Sources of Local Government Financing

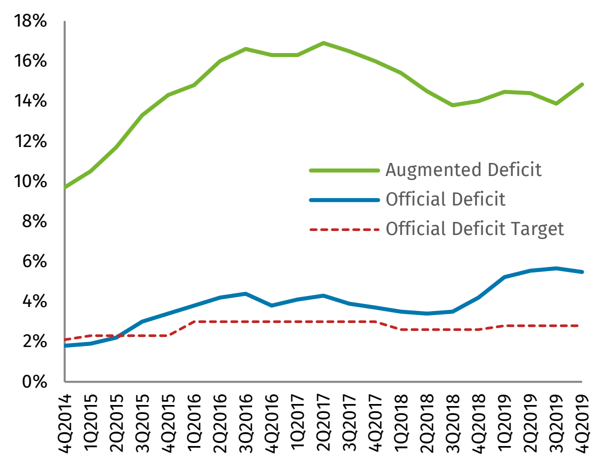
Billion RMB



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

Supplemental 2: Fiscal Deficit Measures

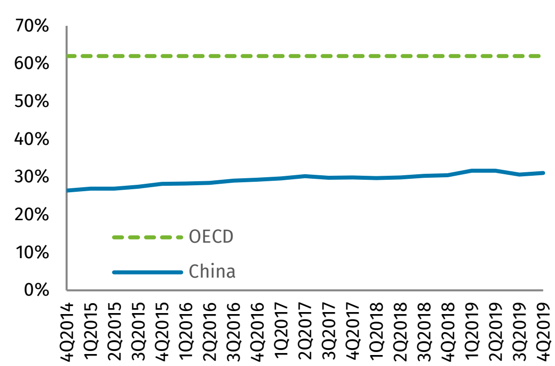
4qma, share of GDP



Source: Ministry of Finance, Rhodium Group.

Supplemental 3: Direct Taxation Ratio

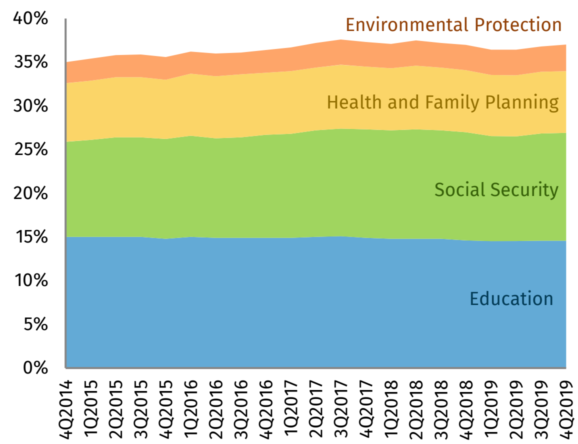
4qma, percent



Source: OECD, Ministry of Finance, Rhodium Group.

Supplemental 4: Government Social Expenditures

4qma, percent



Source: Ministry of Finance, Rhodium Group.

Policy Analysis

Years of putting off financial system and state-owned enterprise reforms have left China fiscally constrained in the present crisis. Early 2020 data show a painful COVID-19 impact on local fiscal balances. Localities are reining in extra-budgetary spending to avoid default and must continue to do so to sustain fiscal solvency.

The major sources of local fiscal intake, taxes and land sales revenue, will both fall sharply as tax breaks are extended and payment collections are postponed to help firms, while property developers cut land purchases to preserve cash amid slowing sales. Evergrande Group, the country's largest property developer, plans to reduce its land reserves by 30 million square meters per year for three years by cutting land purchases from local governments. Budgetary income fell 8.6% in the first two months of 2020, and land sales revenue dropped 16.4% year-on-year.

Some help is on the way. Beijing has raised local bond issuance quotas even though the official 2020 budget target announcement has been delayed. Local government net bond issuance in 1Q2020 exceeded that in 1Q2019 by 200 billion yuan, an effort to fill the gap left by shrinking tax and land revenue.

This means local governments are cutting spending to maintain fiscal balances amid falling revenue. With little room to cut mandatory expenditures, localities will probably reduce land development spending (for instance, anticipatory investment in clearing land and installing infrastructure to attract developers). Regulations limit use of new bond sales proceeds for these purposes: Beijing banned the use of "frontloaded" special revenue bond (SRB) issuance to fund housing and land development in 2019. In March, this ban was extended to all 2020 SRB issuance. This shows Beijing is winding down support for "shantytown redevelopment" programs, which had greatly added to local spending burdens in 2015–2019.

Fiscal support in the form of special treasury bonds is also forthcoming, with unclear implications for the long-term fiscal reform outlook. A March 2020 Politburo meeting announced that these bond sales would combat the COVID-19 impact, but without details. Special treasury bonds have been employed twice before: to recapitalize banks in 1998 and to establish the China Investment Corporation (the sovereign wealth fund) in 2007. In those instances, issuance did not impact local fiscal balances. This time, bond proceeds will likely be used to support local fiscal balances hit by the coronavirus.

The proceeds could be used to fund countercyclical infrastructure spending performed through local government financing vehicles (LGFVs). In the response to the global financial crisis in 2008–2009, LGFVs were encouraged to obtain funding from the murky shadow banking system, rather than official funds. This created the misleading appearance that the Chinese government's fiscal position was more sound than it really was, while abetting the buildup of quasi-official obligations out of the light of day—obligations now causing banks to fail. More direct lending from the central government to LGFVs this time would make the reality more transparent and ultimately provide the funding at much lower cost than shadow banking, reducing future debt-servicing problems.

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 determinizing 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

- We upgrade our assessment of innovation reform in 4Q2019. Innovative industries contributed more to China's economy relative to other industries compared with 3Q2019, but this improvement may be temporary, given that the early Chinese New Year holiday resulted in frontloaded production in December.

- Five out of seven innovative industries outperformed average industrial sector growth. Universal equipment (e.g., machine tools) and auto manufacturing value-added fell behind, with autos sinking to an all-time low growth in 2019.

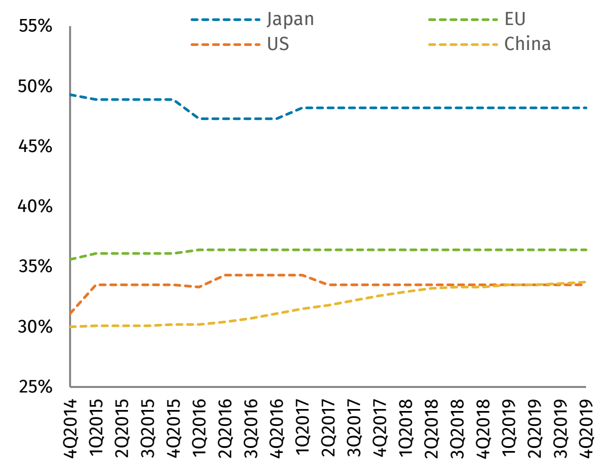
- As economic activities stall due to the COVID-19 response, policymakers are both turning innovative activities into new pillars of the economy and helping more traditional businesses digitize their operations.

This Quarter's Numbers

Innovative industries played a bigger role in China's economy in 4Q2019. Our primary indicator, **Innovative Industry Share in Industrial Value-Added (IVA),** increased 17 basis points compared with a 3-basis point improvement in 3Q2019, indicating an acceleration in innovative value-added growth. Innovative manufacturing industries accounted for 33.7% of total industrial sector value-added, a fraction higher than the last reported U.S. level of 33.6% (as of 2017) but below the European Union average (36.4% as of 2017).

Primary Indicator: Innovation Industry Share in Industrial Value-added

4qma, percentage



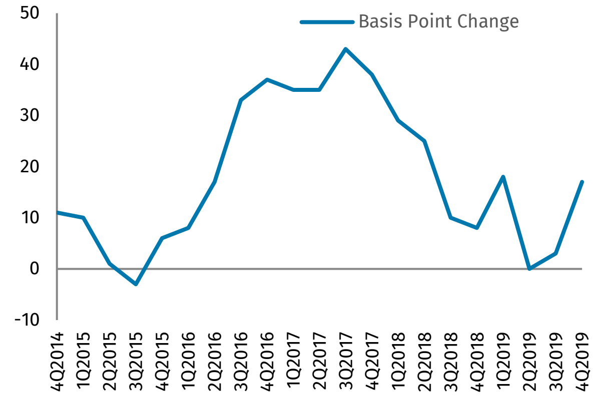
Source: OECD, National Bureau of Statistics, Rhodium Group.

Actual improvement is likely limited and driven by seasonal factors. An early Chinese New Year in 2020 pulled some January production forward to December 2019, contributing to strong performance in the fourth quarter. Relative performance across innovative industries remained unchanged. Five out of the seven industries we track outperformed the industrial sector average, and the other two industries—auto and universal equipment—fell below (see **Industrial Value-Added Growth Rates for Specific Innovative Industries**). The auto manufacturing industry—second largest in terms of total value-added—recorded 1.9% growth in 2019, its lowest on record.

A robust intellectual property (IP) regime is essential for innovation. As IP is better protected, enforced, and utilized, China's payments for the use of IP should increase imports, but 2019 data suggest that progress is stalled. Full-year royalty payments for the use of IP from other countries (IP imports) declined from $35.8 billion in 2018 to $34.3 billion in 2019, while exports (payments by other countries for the use of China's IP) increased slightly from a low base of $5.6 billion to $6.6 billion (see **Intellectual Property Flows**). As a result, China's two-way IP trade with the world actually decreased in 2019.

Supplemental 1: Volatility in Innovative Industry

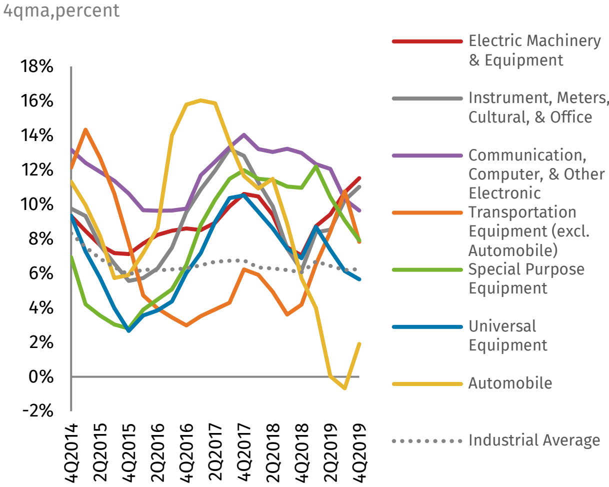
4qma, bp



Source: National Bureau of Statistics, Rhodium Group.

Supplemental 2: Industrial Value-Added Growth Rates for Specific Innovative Industries

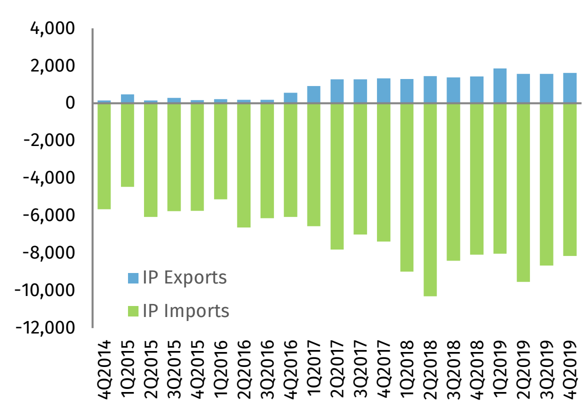
4qma,percent



Source: National Bureau of Statistics, Rhodium Group.

Supplemental 3: Intellectual Property Flows

USD Million



Source: National Bureau of Statistics, Rhodium Group.

Policy Analysis

Policymakers are pivoting to innovative activities as China's economy stalls under COVID-19. Recent policy developments elevate innovation as an economic and political priority, promote digital services and strategic emerging industries, and strengthen IP protection. Such policies include both market mechanisms and industrial policies.

Beijing is elevating innovative industries to become pillars of the economy. An April 2020 *Guideline* jointly published by the State Council and the Chinese Communist Party (CCP) Central Committee aims to liberalize the allocation of factors of production. These include not only conventional inputs of land, labor, and capital but also *technology and data*. China is thus the first country to officially treat data as a foundational production factor, demonstrating Beijing's strong focus on innovation, but it Is unclear how this will work in practice.

In the *Guideline*, Beijing proposes three measures to strengthen the role of data: (1) widening access to public data for all; (2) improving usability and interoperability of private sector data (if data are collected and stored in more standardized and accessible ways, they will become more valuable for more users); and (3) strengthening data source integration and data security protection (to clarify what data can be used for what purposes, while making nonsensitive data easier to use in general). These measures speak to bottlenecks digital industries face in China. Currently, China's enormous databank is woefully underutilized due to restricted access to public data. Underdeveloped privacy and security standards make data exchange risky, and legal ambiguities around privately held data impair marketization. These bottlenecks have impaired China's innovative potential, especially in industries reliant on data and data-enabled applications. China's access to mass data confers a competitive advantage over private and foreign companies. While this change seems to open access marginally, domestic companies stand to benefit more.

The rationale behind the *Guideline* appears market oriented on the surface. It is not the first time that Beijing has tried to boost digital industries (the ambitious "Internet Plus" program was rolled out in 2015). But instead of telling industries what applications they should develop, this *Guideline* focuses on improving institutional conditions with rules and infrastructure. This is moderately positive.

But Beijing has not abandoned industrial policy. At the ministry level, industry targeting is still a common theme in COVID-19 policy response packages. In February 25 guidelines to facilitate reopening the economy, Ministry of Industry and Information Technology (MIIT) listed nine strategic and emerging industries as policy priorities, including industrial robotics and additive manufacturing (3-D printing). Media reported that China's National Integrated Circuit Industry Investment Fund, a government-guided equity fund created in 2014, will start to make investments with its estimated 200 billion yuan second funding round in March 2020, targeting high-end equipment and new materials.

The COVID-19 outbreak response required restricted worker migration and reducing traditional labor-intensive economic activity, thus putting a premium on new industries that minimize human contact. In a February address, President Xi Jinping emphasized that the government should promote digital services to boost household consumption and ramp up 5G applications, e-commerce, and online entertainment. In April, the National Development and Reform Commission (NDRC) identified "new infrastructure" to be prioritized in investment projects: information and communication technology infrastructure, such as 5G and Internet of Things (IoT); "fusion" infrastructure, such as Smart City traffic applications; and infrastructure that supports research and development activities.

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

- We further downgrade our labor reform assessment this quarter. All indicators continued to deteriorate in 4Q2019 and will likely worsen as a result of COVID-19.

- Urban wage growth slowed to a record low pace, even before the outbreak. Government support has been insufficient so far to offset job losses.

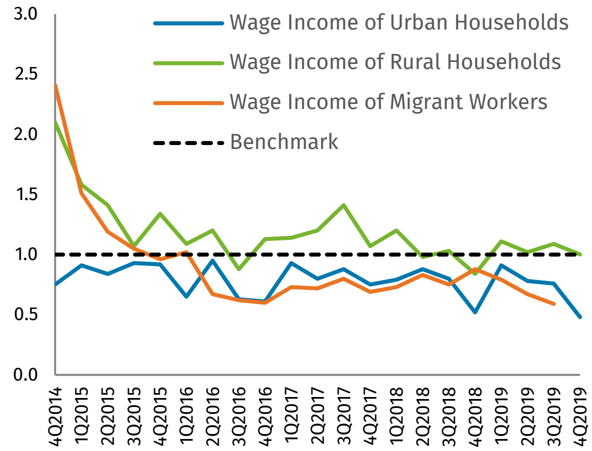
- Policies prioritized economic stability over labor welfare. Vouchers rolled out to spur consumption in a handful of cities may be expanded nationwide but are not a salve for those most in need—migrant workers and the unemployed in poorer areas.

This Quarter's Numbers

Labor conditions weakened across the board in 4Q2019. Urban wage growth dipped to its lowest level on record, nearly 50% below reported GDP growth (see **Wage Growth Relative to GDP**), while rural wages rose at the same pace as GDP but slowed from 3Q2019. (Authorities did not release new migrant wage data this quarter.) China created fewer jobs in 2019 than in 2018, and the unemployment rate increased, suggesting that the reported 6% economic growth failed to support new employment (see **New Job Creation**).

Primary Indicator: Wage Growth Relative to GDP

Ratio



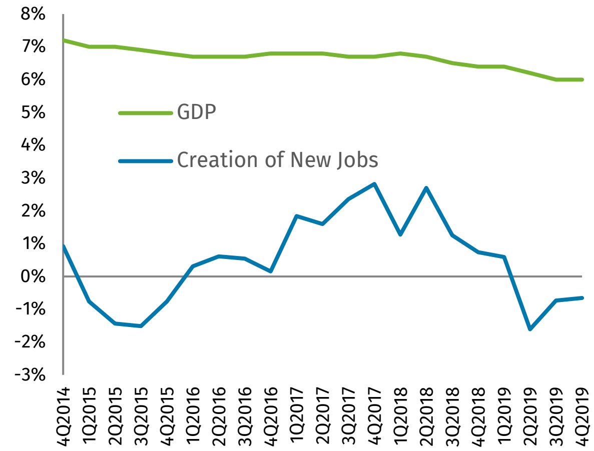
Source: National Bureau of Statistics, Rhodium Group.

The COVID-19 outbreak has made labor conditions worse in 2020. The official surveyed unemployment rate rose to 6.2% in February from 5.2% in December 2019, meaning a loss of around 5 million jobs. As of April, most have returned to work, but tourism and business travel around the country remain 70% below normal levels and some factories are at full capacity, reducing job opportunities and incomes for many. As economic activity in China gradually resumes, the rest of the world has locked down in sequence to grapple with COVID-19, which will cause a second-wave impact on China's economy and slow its recovery.

Fiscal policies have provided little material help to households hit by the crisis. Before the outbreak, fiscal spending on social welfare as a percentage of GDP had been stalled or slowing since 2017 (see **Social Spending**). After the outbreak, most policy support for households has taken the form of vouchers to incentivize consumption in a handful of cities. China's fiscal policy space is limited, however, as revenue is falling as a result of COVID-19 and expenditures on healthcare will rise.

Supplemental 1: New Job Creation

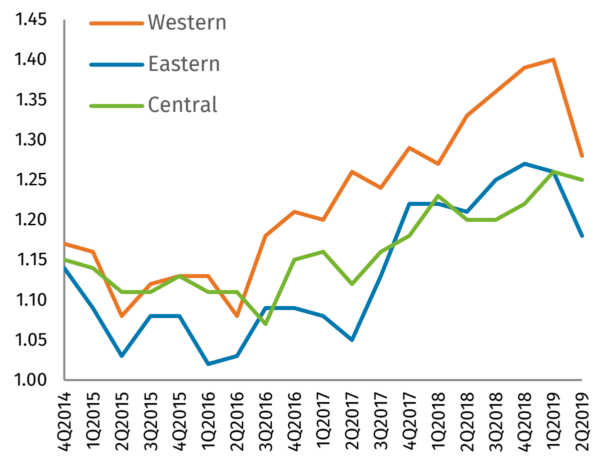
Yoy, percent



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

Supplemental 2: Labor Demand-Supply Ratio

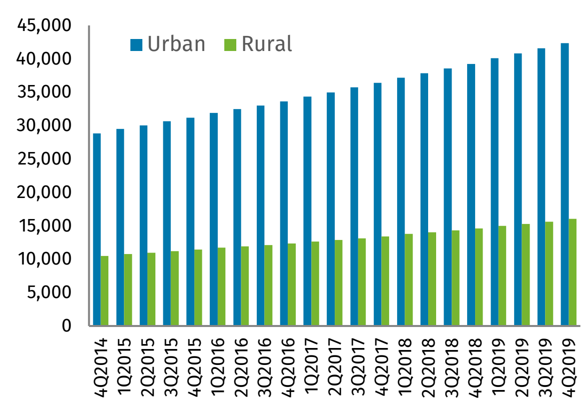
Job openings per applicant



Source: Ministry of Human Resources and Social Security.

Supplemental 3: Rural-Urban Household Income

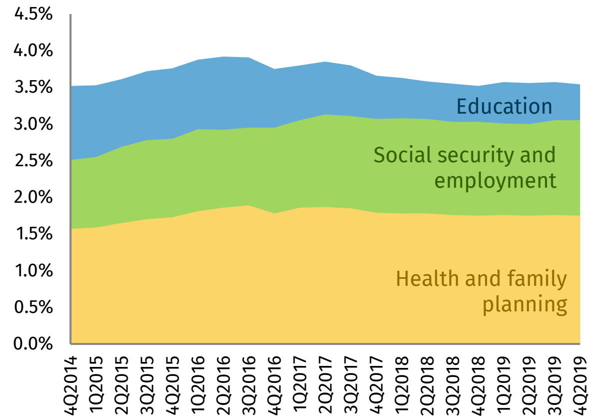
Annualized RMB



Source: National Bureau of Statistics.

Supplemental 4: Government Social Expenditures

4qma, percent



Source: National Bureau of Statistics, Ministry of Finance.

Policy Analysis

Policies in the review period prioritized economic stability over labor welfare. In late 2019 when the virus first emerged, local officials were still developing plans to implement policies discussed at the December Central Economic Work Conference, such as stabilizing the economy and alleviating poverty. Focused on meeting growth-oriented policy goals set by the central government, local governments in Hubei and Wuhan missed their best chance to prevent the outbreak from spreading.

In mid-February when the virus appeared somewhat contained, policymakers turned to economic recovery. Authorities waived pension payments for small and medium enterprises (SMEs) for five months and reduced payments by half for larger enterprises for three months. Waivers will save firms more than 500 billion yuan ($70 billion), which is necessary to help them stay afloat and keep people employed in the short term but will reduce long-term retirement benefits for workers.

Since early March, local governments have started rolling out vouchers to promote consumption, which is a measure to help businesses more than households. These vouchers are not direct cash compensation for workers who face income loss because of the lockdown but are discount coupons that can be used on purchases above a certain amount. For example, in Hangzhou, an experimental program allows a local resident to use a government-issued electronic voucher to save 10 yuan ($1.50) on a 50-yuan ($7.00) local purchase. Hangzhou authorities plan to issue vouchers worth 1.68 billion yuan ($237 million), with around 100 million yuan ($14 million) distributed each round for the first 1.5 million people to claim them, averaging 100 yuan ($14.00) per person. The central and local governments each provided one-third of the total voucher amount in Hangzhou, with companies contributing the rest.

More than a dozen cities have announced voucher programs, but the total value so far is only 10 billion yuan ($1.4 billion). The voucher program may be rolled out in some form nationwide if it proves effective in kick-starting consumption, but many localities are fiscally constrained. Even with a green light from Beijing, there will likely be regional variation in issuance and mismatches between where the money is needed most and where the government actually has resources.

Improving labor conditions under COVID-19 was not prioritized until late March, when the State Council issued an opinion to stabilize employment. In addition to resuming work, the opinion advanced some measures to support vulnerable groups, including arranging transportation for migrant workers to return to work and providing vocational training for the unemployed. The opinion also instructed local governments and state-owned enterprises to recruit more new college graduates.

As of April 2020, a campaign to restoke pro-growth market reforms was underway, including some initiatives on labor policy. On April 9, a joint Communist Party–State Council opinion was issued urging more effective "market allocation" of resources. On labor, the opinion promised to deepen *hukou* reform by improving the system that decides who can migrate to big cities based on scores for employment, home ownership, education, and business. The opinion also called for coordination among cities in the Yangtze River Delta and the Pearl River Delta, which should harmonize regional approaches to migration. The announcement also talks about labor mobility, skills upgrading, and attracting foreign talent, but no new solutions to clearing obstacles to these long-standing nostrums have been offered.

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

- Our land reform assessment remains negative: rural nonagricultural land is not being transferred for more productive uses, despite revisions to the Land Management Law in August 2019.

- Indicators of land reform were mixed. Local governments were more reliant on land sales for revenue, preventing them from relaxing control of this resource. At the same time, however, rural residents still enjoyed stronger property income growth from partial reform of agricultural land.

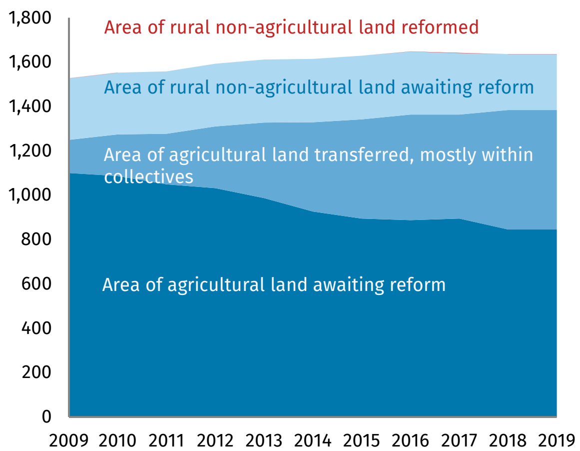
- New policies to decentralize and accelerate rural land conversion approvals have been issued. However, these are not fundamental reforms as the scope of land covered is limited and rural residents cannot directly transfer their nonagricultural land.

This Quarter's Numbers

Land reform did not progress this quarter. China's 2013 Third Plenum Decisions defined land reform as enabling the transfer of rural nonagricultural land at market prices—the same treatment as urban land. Beijing did not update land transfer data in 4Q2019: the area of reformed land remains just 0.1% of China's total rural nonagricultural land by area. If new land transfer pilots announced in December 2019 work, we would expect this indicator to improve.

Primary Indicator: Land Marketized

Million mu (1 mu ≈ 1/6 acre)



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

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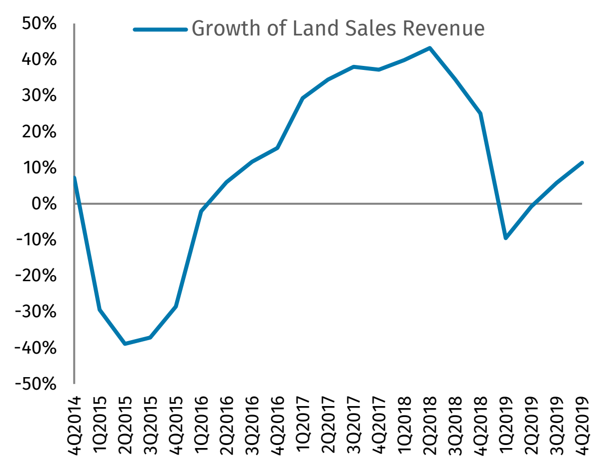
A key obstacle to land reform is local governments' reliance on land sales for fiscal resources, which inclines them to pay below fair market prices for rural land purchases that they then resell at higher prices to developers. Fourth-quarter data show no improvement in this pattern. Extra-budgetary land sales revenue rose 22% year-on-year in 4Q2019, accelerating from 17% in 3Q2019 (see **Land Requisition Financials**). Full-year local land sale revenue was 11% higher than in 2018 compared with merely 2.2% growth of total budgetary revenue, suggesting that land sales reliance increased. A March 2020 State Council decision delegates more authority to local governments to approve land sales and convert agricultural land for nonagricultural use, giving them an even bigger role in this arbitrage—the opposite of stated reform intentions.

Going forward, profit from land sales will almost surely decline, which will likely reduce resistance to reform. Land price growth has slowed for two years due to restrictive property market policies (see **Urban Land Prices**). The new Land Management Law passed in August 2019 requires local governments to compensate rural residents at fair market prices. As stated, this is not yet happening, but the writing is on the wall.

While reform of rural nonagricultural land is stalled, *agricultural* land reform has seen some progress, with benefits for rural households. Property income growth for rural households reached 16.4% in 4Q2019, the second largest increase on record (see **Rural Credit**). Credit to rural households for agricultural activities improved as well, which should support rural property values.

Supplemental 1: Land Requisition Financials

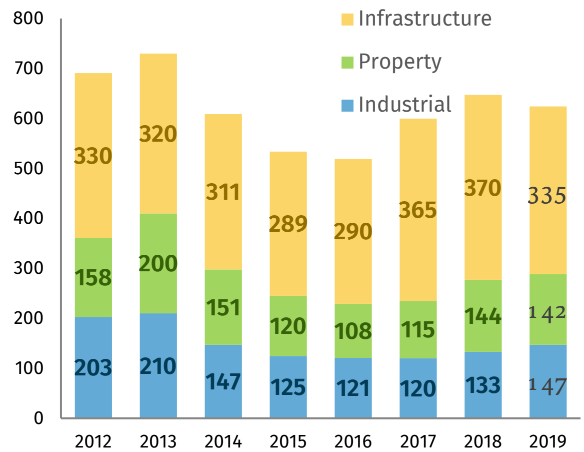
Year-over-year, percent



Source: Ministry of Finance, Rhodium Group.

Supplemental 2: Urban Land Supply by Use

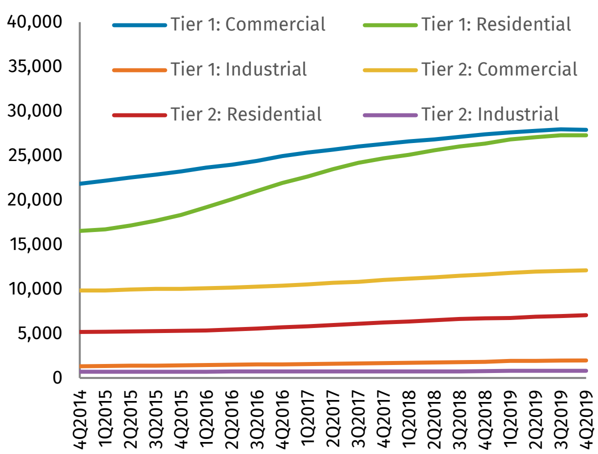
Thousand Ha



Source: Ministry of Natural Resources.

Supplemental 3: Urban Land Prices

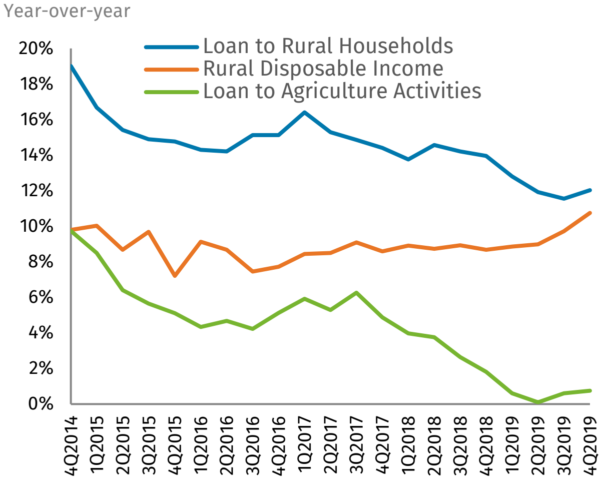
RMB per square meter



Source: Ministry of Natural Resources.

Supplemental 4: Rural Credit

Year-over-year



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

Policy Analysis

Policies targeted both nonagricultural and agricultural land in early 2020. On March 11, the Ministry of Agriculture and Rural Affairs (MoARA) announced that pilot agricultural land reforms would be made national in 2020. On March 12, the State Council empowered local governments to convert agricultural land to nonagricultural use, an authority reserved for Beijing since 2007. An April joint Communist Party–State Council opinion echoed these changes, urging more effective market allocation of resources including market-based pricing of land and better compensation for rural land. These are not fundamental reforms but depending on implementation could permit rural farmers to mortgage their land management rights even if they do not hold ownership.

Decentralizing land conversion authority is a step in the right direction, but local governments are likely to benefit more than rural residents. The State Council will delegate two functions to local governments: converting *nonpermanent* agricultural land (i.e., land that is not critical to China's food security) to nonagricultural use, and converting permanent agricultural land to nonagricultural urban use in eight pilot provinces (Beijing, Tianjin, Shanghai, Jiangsu, Zhejiang, Anhui, Guangdong, and Chongqing). This reverses the policy in effect since 2007, which had centralized conversion approval to ration nonagricultural land supply. By allowing local governments to control rural nonagricultural land supply, Beijing reinforces their position to benefit from land sales. While rural residents may see modest benefits, the fundamental picture is unchanged.

Meanwhile, the MoARA's decision to expand agricultural land reform nationwide may also benefit rural households by enabling them to transfer land use to their collectives to be leased out for large-scale farming or other agricultural purposes. Rural residents would earn dividends from the agricultural output of land transferred. Authorities plan to expand the program to the 16 remaining provinces this year.

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

- Our assessment of state-owned enterprise (SOE) reform remains negative. Listed SOEs played a bigger role in the economy in 4Q2019. Long-standing "mixed ownership reforms" saw some progress, but COVID-19 will likely delay implementation.

- SOEs accounted for a smaller share of industrial assets in 4Q2019, but listed SOEs generated a larger share of all exchange-traded company revenues.

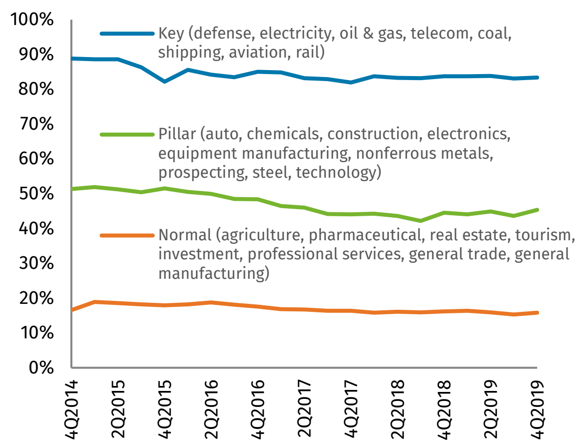
- The COVID-19 pandemic has elevated the role and influence of state firms. Beijing now appears less interested in withdrawing state firm presence than in improving SOE efficiency.

This Quarter's Numbers

State-owned enterprise (SOE) reform backtracked in 4Q2019. SOEs claimed a bigger share of revenue across all sectors we track, reversing earlier improvements. State firm revenue shares increased the most in "pillar" industries considered strategic to China's economic development (from 43.6% to 45.4%), as Beijing leaned on them to stabilize the economy late in the year (see **The State's Share of the Take**). In "normal" industries where Beijing pledged to withdraw state influence, SOE revenue also increased marginally, from 15.3% to 15.8% of the total. In "key" industries considered strategic to China's national security, the already high SOE revenue share also increased (to 83.3%).

Primary Indicator: Share of SOE Revenues in Different Industry Categories

4qma, percent



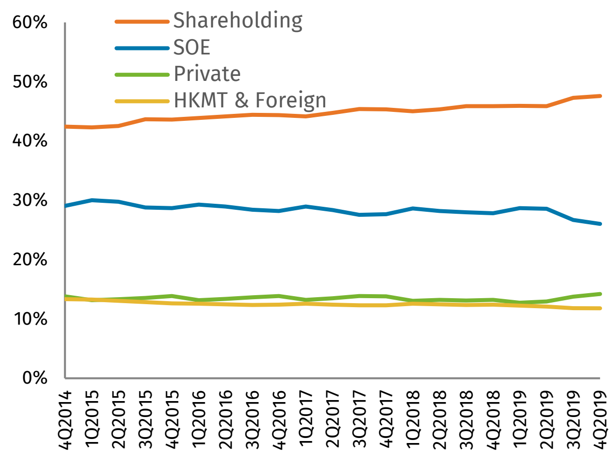
Source: Bloomberg, Rhodium Group.

There are indications that Beijing still intends to pursue SOE reform but has picked easier targets: restructuring unlisted firms. This is less complicated than dealing with listed firms, given regulatory requirements and potential market impacts. Industrial SOE asset growth declined from 1.3% in November 2019 to −2.4% in December, while private firm asset growth saw a corresponding uptick in December (15.1% from 13.5% in November). This likely reflects another reclassification of SOEs as private firms in December, after a previous round in August (see **Winter 2020 Edition**). As a result, private asset share increased to 14.2% in 4Q2019 from 13.8% in 3Q2019, while the SOE asset share decreased slightly (see **Industrial Assets by Ownership**).

The reclassification is an ongoing story. In March 2020, the State-Owned Assets Supervision and Administration Commission (SASAC) announced that under the "double-hundred actions" campaign, 41.6% of SOE group holding companies and 62.7% of subsidiaries had achieved "mixed ownership"–adding private shareholders. More than 70 SOE group holding companies and dozens of their subsidiaries need to be reclassified, which is likely to involve several hundred billion yuan in assets. This is on the same scale as the 1.5% additional growth in private assets, which stood at 24 trillion yuan ($3.4 trillion) at the end of 2018, suggesting mixed ownership reform is the driver of this change.

Supplemental 1: Industrial Assets by Ownership

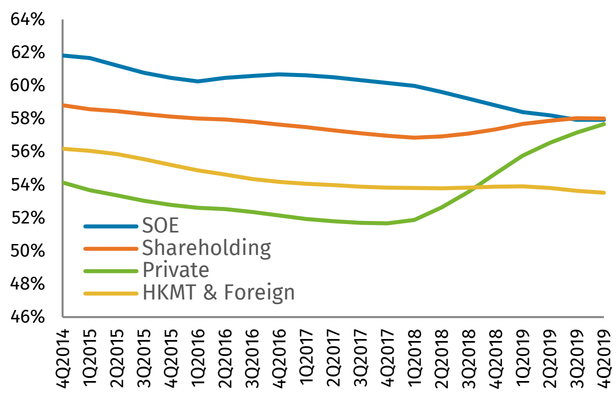
Percent



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

Supplemental 2: SOE Leverage

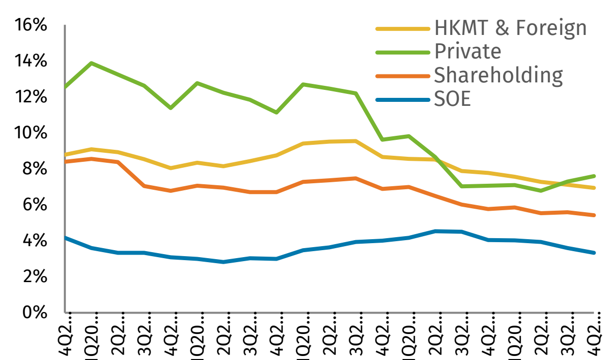
12mma, percent



Source: National Bureau of Statistics, Rhodium Group.

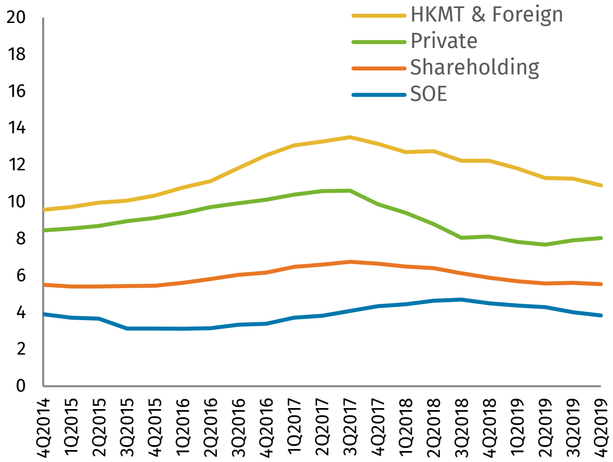
Supplemental 3: Return on Assets

Percent



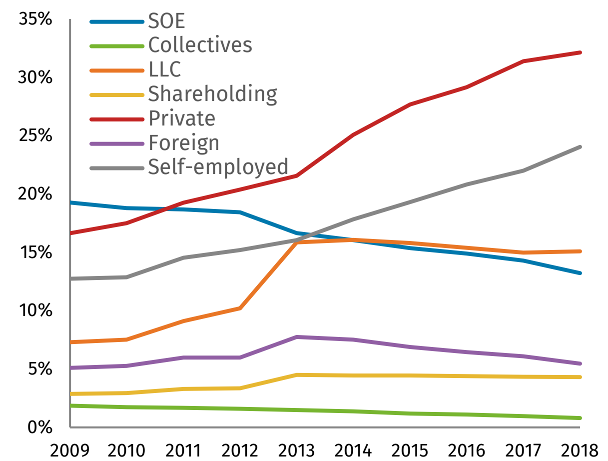
Source: National Bureau of Statistics, Rhodium Group.

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

The COVID-19 pandemic has changed the SOE reform landscape. In the 2013 Third Plenum, Beijing promised to reduce state influence in normal commercial industries and concentrate power in strategic ones. The pandemic elevates the role of SOEs, both politically and economically. Beijing appears less interested in withdrawing state presence and more likely to sustain SOE influence over the economy while improving their efficiency.

SOEs were central to China's response to the virus outbreak, for example, by building new hospitals in Wuhan in just a few weeks, maintaining supplies of key materials, supporting other firms by waiving rent (or simply paying their arrears), and helping to stabilize employment while most of the private sector was forced to shut down. President Xi Jinping visited a Shaanxi automobile SOE on April 22 and praised SOEs as "the main force" in supporting China's economic recovery. This signals that SOEs will maintain a strong presence not only in key but also in pillar industries.

The government also increasingly relies on SOEs to supplement a growing fiscal shortfall. In 2019, Beijing extracted 772 billion yuan ($110 billion) from SOEs, 120% more than in 2018. Both central and local SOEs are required to transfer 10% of state-owned equity to social security funds (SSF). By 2019, central SOEs had transferred 1.1 trillion yuan ($160 billion) in equity to the central SSF, and local SOEs are expected to transfer a similar amount to local SSFs in 2020. Increasing SOE payments to the state is a reform goal itself: as state firms, SOEs bear national financial obligations, and mandated dividend payments are supposed to instill budgetary discipline. However, this reliance incentivizes the government to shelter SOEs to protect that dividend income, especially when it cannot easily sell SOE shares at competitive prices in financial markets.

In lieu of withdrawing state influence, China announced three measures aimed at improving SOE efficiency. None appears promising. First, Beijing will establish a new central SOE, Rong Tong Asset Management Group (Rongtong), to manage defense SOEs' commercial businesses. Rongtong leaders will still be appointed and evaluated by the state; however, their objectives are unlikely to be purely commercial. Second, SASAC is cracking down on SOE investment in non-core businesses like real estate, but enforcement is lax given the size and complex structure of SOEs. Third, on April 9, President Xi reiterated a reform plan for market allocation of production resources. But instead of reducing SOE power in non-strategic industries, the plan focuses on SOE salary reform and improving SOE corporate governance. The latter likely includes strengthening party building, which will inherently make SOEs more responsive to political priorities and less to market dynamics.

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

- Our trade policy reform assessment remains neutral for 4Q2019. Rising imports and stable exports were consistent with reform goals, but improvement was temporary, driven by seasonal holiday effects. The COVID-19 crisis reshaped China's trade patterns in 1Q2020.

- Imports of consumer goods increased, and net exports of overcapacity goods remained stable or declined. China's overall goods trade surplus moderated, and its non-tourism service imports increased modestly.

- Policy developments included both trade opening and trade restrictions. China has taken steps to implement some provisions of the Phase One deal it signed with Washington on January 15, 2020, but the purchasing commitments it made are vanishingly unlikely to be met. The impact of COVID-19 and its political and economic fallout are prompting more trade restrictions as critical medical and protective equipment demand surges worldwide.

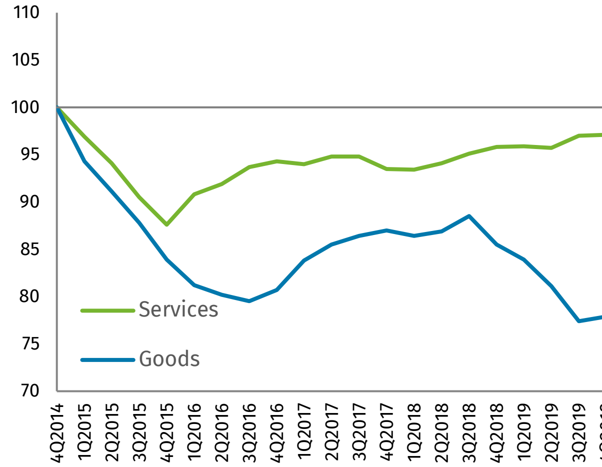
This Quarter's Numbers

China's import openness improved marginally in 4Q2019 from the previous quarter but remains below levels seen at the start of President Xi's reform era. Our **Composite Trade Liberalization Index** (CTLI) proxies goods imported into China for final consumption (excluding major commodities such as crude, iron ore, and integrated circuits) and services imports excluding tourism.

After falling throughout 2018 and 2019, goods imports stabilized in the fourth quarter. As our **External Trade** indicator shows, stronger imports and stable exports caused China's goods trade-to-GDP level to fall slightly in 4Q2019. At the same time, China's net exports of overcapacity goods (measured by volume) all declined or stabilized (see **Trade in Overcapacity Goods**). These patterns are consistent with greater trade liberalization but more likely reflect temporary conditions. An early Chinese New Year in January caused manufacturers to frontload activity in December (imports contracted throughout the first three quarters of 2019). Most of the import increase was driven by integrated circuits—a semiconductor component, indicating stockpiling amid U.S. trade tension—and soybeans, demonstrating trade war distortions.

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.

The CTLI services trade sub-indicator continued to improve through 2019. Outside of tourism, most services imports increased in 4Q2019 compared with 4Q2018, driven by "other commercial services" that include legal, consulting, engineering, and other professional services. The biggest shift has been China's growing services exports. Telecom and computer services and financial services exports rose, expanding China's surpluses in those categories (see **Services Trade Openness**). However, China's full-year 2019 services deficit got smaller: exports rose, and outside tourism imports (which contracted in 2019 for the first time since 2003), the remainder of non-tourism services imports rose by only 1%.

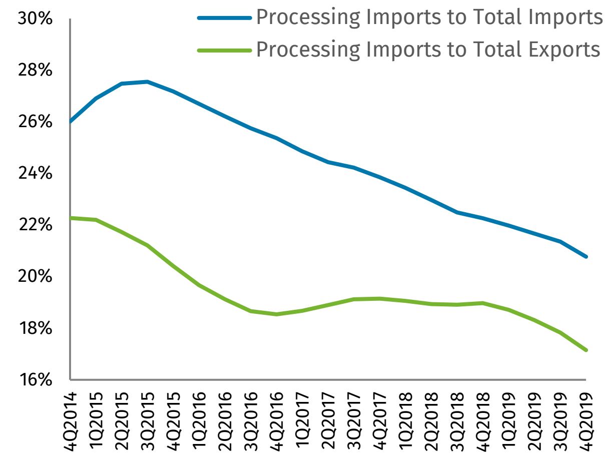
Supplemental 1: External Trade

Percent

Source: State Administration for Foreign Exchange.

Supplemental 2: Structural Change in Goods Trade

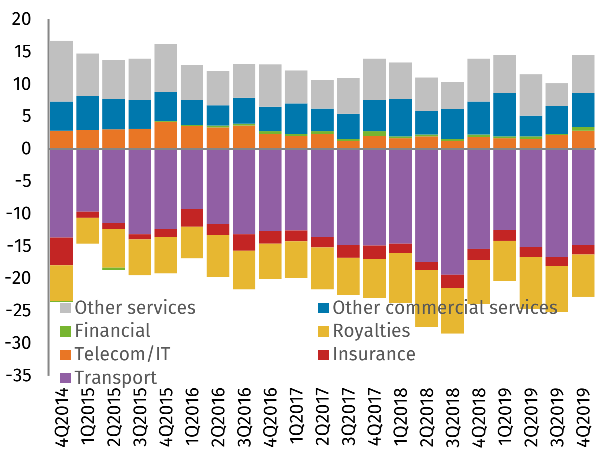
Percent



Source: General Administration of Customs.

Supplemental 3: Services Trade Openness

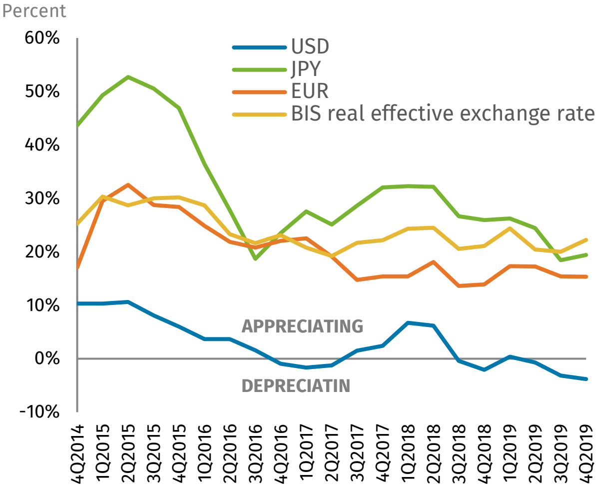
USD Billion



Source State Administration of Foreign Exchange.

Supplemental 4: Exchange Rate Fluctuation

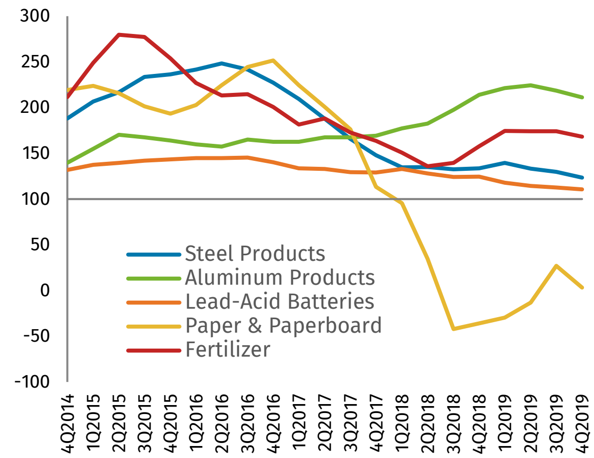
Percent



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

Supplemental 5: Trade and Overcapacity

Index, 2012=100



Source: General Administration of Customs, Rhodium Group.

Policy Analysis

The key question for trade reform now is how China will respond to the exceptional circumstances created by the COVID-19 crisis. Policy developments in recent months included both trade opening and trade restrictions, but the fundamental factor at work is physical supply and demand realities around the world.

China has continued to reduce tariffs on U.S. products levied under the U.S. Section 301 case. In mid-February, the State Council Tariff Commission reduced September 2019 tariffs from 10% to 5% for 916 goods (including seafood, fruit, vegetables, cereals, edible oils, and leather), and from 5% to 2.5% for 801 goods (including dairy products, canned food, and mineral products). In May, China's Finance Ministry announced additional tariff reductions for 79 U.S. imports amounting to around $2 billion annually, most of which are chemicals and appear related to medical and protective equipment.

China has implemented a series of Phase One deal commitments according to the timetables specified in the agreement. In April 2020, China's supreme court published guidelines strengthening its intellectual property (IP) enforcement, enhancing trade secret protections, and increasing penalties for IP rights violations. In agriculture, China has implemented more than half the agreed-upon provisions to dismantle technical trade barriers, according to U.S. Agriculture Department officials, but its ability to meet purchase targets is questionable given the hit to domestic demand from COVID-19. The deal includes a provision mandating consultations in the event of "a natural disaster or other unforeseeable event," but as of late May, U.S. and Chinese officials said the deal remains intact and China plans to implement it. President Trump has indicated China's failure to meet targets could be met with more U.S. tariffs, withdrawal from the agreement, or cancelation of U.S. debt obligations with China, while also acknowledging limitations on China's ability to meet targets under coronavirus impacts. While the deal was unlikely to stabilize the bilateral relationship even pre-COVID, the pandemic and the heated back and forth between U.S and Chinese officials since its spread diminish that possibility even more.

Broader U.S. export controls and strong signals of mounting geoeconomic competition will limit any bilateral trade rebound. U.S. trade policy aggression also risks retaliation from China. In April, Beijing temporarily imposed export restrictions on critical medical equipment and protective gear. Official intentions were to ensure domestic supply and to control quality, after some governments reported receiving faulty ventilators and tests from China. China's Ministry of Commerce, the General Administration of Customs, and the State Administration for Market Regulation have since relaxed export certification requirements as spiking demand around the world has put supply chains under pressure. Several governments are advocating for re-shoring manufacturing activity to boost domestic production and reduce reliance on imports from China.

COVID-19 has reduced China's goods imports and exports by 2.4% and 11.3% year-on-year, respectively, which will complicate the reform outlook. China has proceeded with several waves of U.S. tariff reductions to reduce costs and has resumed some U.S. purchases. However, the coronavirus's shock to domestic activity caused goods exports and tourism imports to fall sharply. The political fallout from the virus outbreak is causing some governments and companies to reconsider their reliance upon supply chains from China. At the same time, China is ramping up domestic production capacity—likely to be in high demand in 2020—which could lead to overcapacity in the future. If these mitigation strategies become a reality, they will reshape China's trade patterns in the quarters to come.