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?