

China Dashboard Winter 2019 Update

February 2019

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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.

NET ASSESSMENT WINTER 2019 CHINA DASHBOARD

THE STORY SO FAR

In the decades following China's 1978 decision to reform and open, its growth was driven by demographics and structural adjustment – letting market logic reshape the economic landscape. But in recent years, as the easier phase of development gave way to middle-income challenges, Beijing has attempted to reassert control over investment and markets. This was not the first choice. President Xi Jinping's inaugural 2013 Third Plenum economic plan – while still couched in Communist Party nomenclature – was distinctly geared toward a decisive role for markets. Implementation of those goals, rather than aspiration, has been most lacking. By tracking China's own 2013 objectives across 10 economic domains, The China Dashboard seeks to inform public debate with objective data on just how close to or far from those aspirations China is trending.

Gauging China's policy progress objectively is essential for understanding what sort of economy – and polity – China will have domestically in the future, and just as critically what role China will play in the international community. The current tensions between China and the United States represent the sort of situation we previously anticipated at the conception of the Dashboard project and seek to temper through the dissemination of respected data indicators and interpretation. For this reason, we eschew normative advice or prognostication about the future of the Chinese economy, though we do point out clear conundrums in the outlook.

BOTTOM LINE

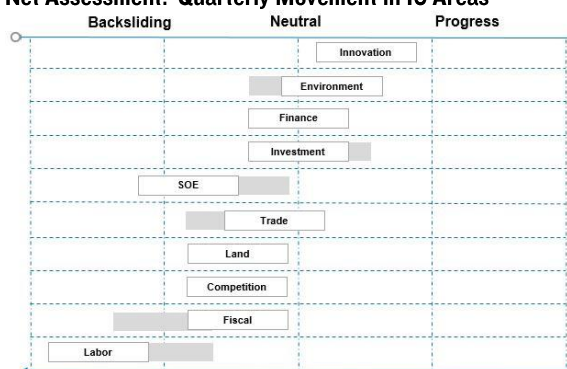
The China Dashboard offers a regular assessment of China's progress or regress on its own critical policy goals. The record more than five years after the Third Plenum plan was laid down remains in negative territory against the objectives set in 2013. For this Winter 2019 edition, we do not see market reform moving forward in 8 of the 10 areas we track. This is a continuation of what we observed in the previous Fall 2018 edition.

This edition goes to press less than one month from the March 1 deadline in U.S.-China economic negotiations. The complaints that impelled these talks focused on trade and intellectual property, but in actuality the agenda is much broader and deeper, cutting to the core of China's economic model. Negotiations will include a focus on reducing the U.S. trade deficit with China through Chinese commitments to purchase U.S. goods and energy. This is the easy part. However, Washington also insists on fundamental structural economic reforms in China that would require no less than China's reshaping its economic system.

It is unsurprising that China is resisting this demand. Chinese purchases of U.S. natural gas cargoes can be verified easily, ship by ship. But structural reform requires that China make the market decisive in its economy, not just promise a managed trade plan that would temporarily alter the U.S.-China bilateral balance at the expense of third nations. Without such commitments, any short-term outcome of the talks will not put U.S.-China economic relations on a sustainable path. And to assess how close or far we are from that path, we need a broad-spectrum, objective view of China's policy priorities.

This is the moment our Dashboard was made for—to gauge whether this transformation is happening. As of Winter 2019, we see modest forward movement in only two areas: [Environment](#) and [Innovation](#). In other areas, we find that reforms are either stuck in neutral ([Cross-Border Investment](#) and [Financial System](#)) or worsening ([SOEs](#), [Trade](#), [Competition](#), [Fiscal Affairs](#), [Land](#), and [Labor](#)). Each of these clusters is explored in depth in its respective section of the Dashboard.

Net Assessment: Quarterly Movement in 10 Areas



We see multiple factors behind this lack of momentum. First, leaders lack conviction about the emphasis to be placed on reform, with official rhetoric emphasizing Party control rather than ongoing progress toward structural changes in the economy. This likely reflects a political aversion to the potentially destabilizing risks of rapid economic reform efforts, though as we argue throughout the Dashboard a failure to reform will prove just as risky, if not more so over time. Second, a serious growth slowdown is underway in China today, making reform more painful at this point in the cycle – though the lack of reform must be understood as a cause of that slowdown as well. Third, there may simply be a lack of experience and competence to implement the increasingly sophisticated reform measures that China, as a more advanced economy, now needs. Alternatively, officials may be “storing up” reform pledges for commitment in negotiations with the United States.

This is a common phenomenon, where a negotiation causes reforms to be delayed rather than undertaken in a timely manner. Whatever the mix of reasons, the bottom line is the same: China is not making headway toward its own reform objectives, which creates concerns about both the domestic consequences and external tensions.

THE DASHBOARD GAUGES: PRIMARY INDICATORS

Most of the policy areas we evaluate play a role in U.S.-China economic tensions, and China's relations with other advanced economies as well. Of these, three are central to the current outlook.

First, [SOE](#) reform progress appears to be backsliding once again this quarter. Our indicators show SOEs advancing at the expense of private firms, with proposed solutions focused on increasing Party supervision instead of reform. We have watched over the past year as private sector firms were hurt disproportionately by government-led capacity cuts and controls on credit, while SOEs enjoyed better pricing power, maintained access to credit, and sometimes were able to acquire troubled private firms. This continued through the current review period, feeding an increasingly global uproar over the unlevel playing field between state-owned and private or foreign firms in China. Beijing acknowledged the pressures bearing on private firms (it had little choice, given the volume of public concern) but proposes to redouble state support rather than liberalize. Meanwhile, in many OECD capitals the concern about unfair competitive conditions has spread beyond nominally state-owned Chinese firms to include any firms lauded as national champions in China.

Our assessment of [Competition](#) policy reform remains negative, as this domain becomes a key focus of international pushback. Foreign firms are still targeted disproportionately in merger reviews in China despite bureaucratic reforms meant to level the playing field. All supplemental data point to continued weaknesses in China's competitive environment: judicial transparency remains inadequate and foreign investment is slowing. If the state were withdrawing from the normal marketplace, then some residual but shrinking inequalities could be tolerated and mitigated; but with the current resurgence of state firms over private, the damage done by an unlevel playing field multiplies. Competition policy has not been a central part of the U.S. negotiating agenda with China; not everyone in Washington is comfortable opening that Pandora's box, as it would provoke examination of competitive

conditions in advanced economies as well. But China's deal-by-deal promises to clear key transactions taken hostage – like Qualcomm-NXP – are bringing competition policy to the fore.

[Financial System](#) reform is arguably the most fundamental requirement for China to secure a more market-based economic future. That must mean both cleaning up risks and opening up to competition, both in terms of risk-based capital allocation between private firms and SOEs and in terms of foreign investment into domestic financial markets. A deleveraging campaign to de-risk China's financial system continued into the review period, with such powerful effects (evidenced by slowing growth) that it may now be dialed down. The campaign reduced financial risks from banks' funding channels, which were starting to resemble those in the United States before the global financial crisis, but consequently increased economic risks as less credit flowed to firms and households. This is a major driver of the current slowdown. Our primary indicator shows that financial reforms, such as they are, are not leading to *better* credit allocation yet, as far too much capital investment is still required to drive additional economic output.

We can report qualified progress in two areas this quarter. In our last edition, we downgraded our assessment of [Environment](#) policy reform from positive to neutral in light of deterioration in air and water quality, which we attributed to Beijing's softening environmental controls to support growth. This quarter, China moves back into modest positive territory as both our air and water quality indices improved. But progress was not uniform: Beijing City's large improvement in air quality was an outlier, and modest improvements in water quality likely resulted from declining industrial activity. This means conditions would likely deteriorate if the government uses stimulus to boost heavy industrial growth.

As in past editions of the Dashboard, we give Beijing credit on [Innovation](#) for increasing the share of higher-technology industries in the manufacturing sector. The data tell two interesting stories in this period. The first is that U.S. trade action against China has had minimal impact on its innovation goals so far, as China continues to provide considerable political support behind high-technology industries in line with its Made in China 2025 strategy. Second, the concentration of foreign firms in innovative sectors is helping high-tech sectors outperform a slowing Chinese economy.

We modestly upgrade our assessments in two important clusters; however, they remain in negative territory and

subject to backsliding. We upgrade [Trade](#) reform because China's external trade surplus declined during the review period: the \$23.4 billion current account surplus in 3Q2018 was the lowest for a third quarter since 2004, driven by shifts in both goods and services trade. However, these data improvements result from the effects of high oil prices and significant spending on tourism services, rather than more sustainable trends.

A surge in local government special revenue bond issuance drove the largest quarterly improvement in our primary indicator of [Fiscal Affairs](#) reform in six years. However, while developing new financing channels for indebted local governments is important, Beijing also recently allowed local governments to extend and restructure their hidden debts from local state-owned enterprises rather than repay them. This is a step back for fiscal improvement, reinforcing dangerous expectations that high-yielding, high-risk local government financing vehicles are going to be guaranteed and bailed out by Beijing rather than allowed to fail.

THE VIEW FROM ABROAD

Inside China, the discussion of structural economic reform turns on how to reconcile the need for market-supportive changes with the primacy of the Communist Party's role in delivering growth. Abroad, attention is fixed on the Trump administration's stark insistence that China must agree to a full panoply of structural reforms – as well as massive purchases of U.S. exports – by the end of a 90-day window (March 1) or face a further escalation of tariffs. Over the past year, the Trump team treated “marketization” as too abstract and intractable, resulting in the preference for short-term transactional deals focused on reducing the trade deficit with China. But as the March deadline for talks approaches, the importance of these policy matters has risen, with tremendous attention now being paid to the questions we consider in the Dashboard: Can China and the world agree on a common framework of indicators to manage their conversation about economic engagement?

As the profundity and difficulty of China's structural reform agenda have become clearer to observers, some have grown pessimistic, either because they conclude that a deal will not be possible or because they assume the liberal economies will have to compromise.

But there is also a case for optimism. Over the past six years, Beijing has tried fairly hard to implement many of the first-order structural reforms that Washington and other capitals are now advocating. Sagging

economic growth and the gloomy consequence of rebuffing the U.S. calls for change should strengthen the case for China's economic reformers. Their influence will ride on their ability to rebrand the reforms sought by the United States in bilateral economic negotiations as positive adaptations for China's domestic economic growth.

Whether as a justification for disengagement from the bilateral economic relationship or a basis to moderate its bellicosity, Washington will be looking at indicators of China's economic policy arc in choosing its path forward in the bilateral relationship. Verification and enforcement are core components of the U.S. negotiating package, and structural changes will need structural evidence. The China Dashboard is a key tool for this assessment.

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 to favor the interests of state-owned firms over consumers – and domestic firms over foreign – 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. As a result, new business registrations have risen steadily in recent years, and in 2018 the World Bank recognized this progress by substantially increasing its ranking of China’s “ease of doing business” compared with that of 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. 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 updated several competition-related laws after 2013 to reflect changing market conditions. In November 2017, China revised its 24-year-old Anti-unfair Competition Law (ACL) to cover newly 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, though unequal enforcement between state-owned enterprises, foreign companies, and domestic firms remains a major concern.
- In March 2018, China’s National People’s Congress 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, 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.

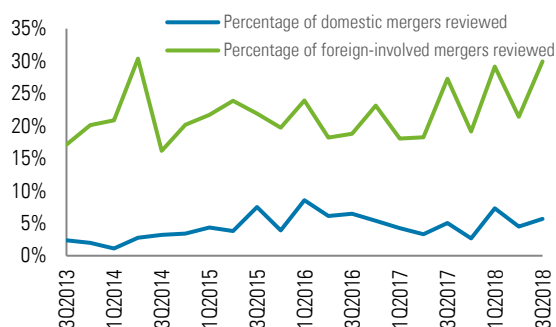
METHODOLOGY

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 SAMR. Supplemental data look at the number of merger cases reviewed, disclosure of the results of competition-related court cases, new business starts and closures (market entries and exits), and the ability of firms to obtain viable profits in healthy markets.

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Merger Reviews

4qma, percentage



Source: Ministry of Commerce, Bloomberg, Rhodium Group

- Our assessment of competition reform remains negative this quarter: foreign firms are still targeted disproportionately in merger reviews despite bureaucratic reforms meant to level the playing field.
- All supplemental data point to continued weaknesses in China’s competitive environment: judicial transparency remains inadequate and foreign investment is slowing. If the state were withdrawing from the normal marketplace, then some residual but shrinking inequalities could be tolerated and mitigated; however, with the current resurgence of state firms over private, the damage done by an uneven playing field is multiplying rapidly.
- New policy discussions center on “competitive neutrality” – the objective of treating state-owned and private firms equally – but thus far Beijing’s variant of this concept places a greater emphasis on defending

Chinese state-owned enterprises' (SOEs') interests abroad rather than constraining their market power at home.

THIS QUARTER'S NUMBERS

Our primary indicator reflects a wide gap in the competitive environment between foreign and domestic companies in China. Out of 92 merger reviews undertaken by the Chinese government in 3Q2018, 59 involved foreign companies: that is, 30% of all mergers involving foreign entities were called in for review, a high percentage. Only 33 Chinese-only mergers were reviewed despite a vastly larger number of merger announcements: just 6% of announced cases were examined. In addition, two important mergers involving foreign companies were approved with restrictive conditions. Beijing has never once imposed conditions on approval of a domestic merger since the Antitrust Law took effect in 2008.

Judicial transparency around competition-related cases improved modestly this quarter but remained woefully inadequate. China's Supreme Court published 3,841 cases related to competition and intellectual property disputes (see **Judicial System Transparency**), more than the previous two quarters combined, but the volume of published cases is still tiny compared with the more than 200,000 such cases handled by the Chinese courts each year. The Supreme Court [announced](#) during the review period that it accepted 700 antitrust cases and concluded 630 of those between 2008 and 2018, but its website only published 73 cases from that 10-year period. Judicial opacity makes it difficult to know if competition laws are being fairly applied, and for foreign and domestic firms to effectively understand and navigate China's complex competition policy environment.

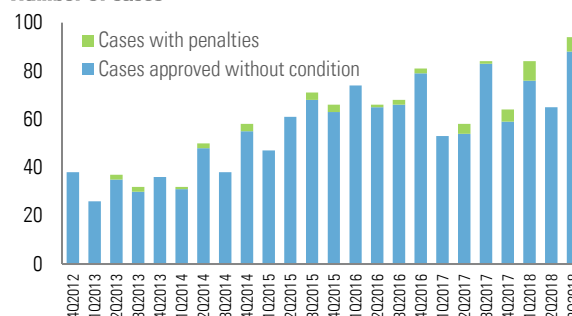
In our last edition, we flagged that the 18% year-on-year (yoy) increase in new business registrations in 2Q2018 was surprising and suggested that a spike in foreign-owned entity registrations was temporary. New business registrations slowed to a more reasonable level in this review period, with growth down to 9% yoy in 3Q2018 (see **Market Entry and Exit**). Total registered capital for foreign entities established in the first nine months of 2018 was only 0.1% higher than the same period last year. While streamlined administrative procedures aided the overall growth of new business registrations, other factors risk scaring foreign investment away. Both unilaterally and in talks with the United States, China is contemplating structural reforms, including more earnestly prohibiting formal and informal technology transfer requirements and freeing investors to repatriate their profits. Over the

past year Beijing has also reduced or eliminated joint venture requirements and caps on equity shares in promising domestic sectors like automotive manufacturing and financial services, though other barriers to foreign investment in these industries remain prohibitive. While these moves offer an exciting prospect of a new age for foreign investment, China's politicized detention of foreign nationals as a negotiating tactic has injected a toxic element, causing foreign business professional and citizens to rethink working in, touring, and otherwise traveling to China.

The distortions in China's competition environment principally benefit the state-owned corporate sector, which has performed better even while industries are consolidated and credit growth slows to reduce financial crisis risks. Tighter credit conditions in the aggregate had the unintended effect of making capital more available to SOEs relative to private firms (see **SOE and Financial System** reform). This access to capital is crucial, because our data show SOE pricing power (ability to generate profit) deteriorating by 11% in the review period – to the lowest level in eight years (see **Pricing Power Index**). While private firms' pricing power increased during the review period, they still suffered from unequal access to credit relative to state firms. Cycles of thinning profitability are natural in market economies: they are the crucible in which tomorrow's dynamism and competitiveness are formed, as less-profitable firms are compelled to exit the market, creating space for more promising players to grow. But if there is not equal access to capital, these phases of the cycle will have the opposite effect: promoting survival of those most under the government's wing rather than those attuned to the marketplace.

Supplemental I: Results of Merger Reviews

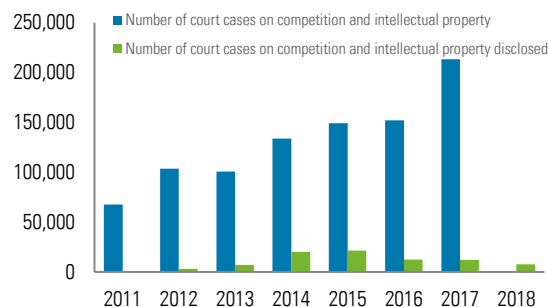
Number of cases



Source: Ministry of Commerce, Rhodium Group.

Supplemental 2: Judicial System Transparency

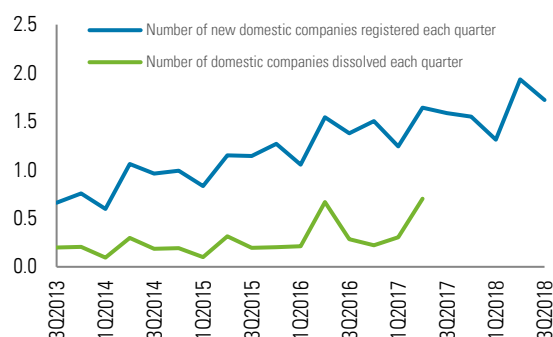
Number of court cases



Source: Judgements Online, Supreme Court.

Supplemental 3: Market Entry and Exit

Millions



Source: State Administration for Industry & Commerce, Rhodium Group.

Supplemental 4: Pricing Power Index

Percentage



Source: Bloomberg, Rhodium Group.

POLICY ANALYSIS

The most important competition policy development in the review period was renewed discussion of competitive neutrality as an approach to managing the state in the marketplace – an objective included in the 2013 Third Plenum. On October 15, People's Bank Governor Yi Gang said at a G20 banking seminar that China will “consider treating SOEs with the principle of competitive neutrality.” The term has engendered decades of debate and redefinition in OECD circles as a

possible tool for managing the behavior of state enterprises operating in fundamentally market-oriented economies. Different views remain on the approach among advanced economies; how the concept would apply in an economy where market forces are far from fundamental (China) is unclear.

Governor Yi's concern with eliminating the inequalities facing private and foreign firms in China may be a positive step. However, on the same day Yi made his remarks State-owned Assets Supervision and Administration Commission (SASAC, overseer of China's nonfinancial central SOEs) spokesman Peng Huagang explained that Beijing was interested in competitive neutrality as a framework for defending SOEs' interests abroad, not for limiting their privileges at home. In his response to a G20 proposal to apply different regulatory standards to SOEs, Peng argued that “China advocates neutrality of ownership, opposes setting different rules for companies of different ownership, and opposes discriminatory treatment of SOEs in the formulation of international rules.”

The Ministry of Commerce (MOFCOM) made a similar argument in December when it published a set of proposals for reforming the World Trade Organization (WTO). MOFCOM called for WTO reform to “respect members' development models,” including “legitimate developmental models and policy measures, such as state owned enterprises and industrial subsidies,” and stated that China opposes “special and discriminatory disciplines against state owned enterprises.”

Despite the focus on competitive neutrality as a means to protect SOEs abroad, some officials see its application at home as well. On November 5, SAMR head Zhang Mao stated his agency would “adhere to the principle of competitive neutrality, that is, to apply neutrality on regulations, taxes, and lending to SOEs and private firms, and will treat all market entities equally.” On November 25, a number of well-respected Chinese economists participated in a National Development and Reform Commission forum where they urged Beijing to prioritize competition and SOE reform over smaller administrative fixes. The debate over how to apply this concept to China's present challenges is just getting started.

CROSS-BORDER INVESTMENT

THE STORY SO FAR

China is deeply engaged with the global economy through trade links, but far less integrated with 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 the 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 whereby 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 Investor (QFII) and RMB Qualified Foreign Institutional Investor, (RQFII)), investors are now able to utilize 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.
- 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

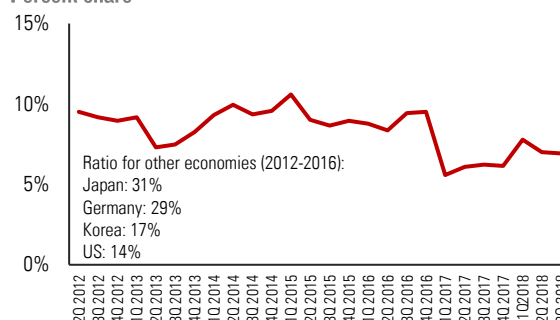
To gauge cross-border investment progress, we sum the volume of capital flows into and out of China on a quarterly basis and divide by gross domestic product (GDP) in the same quarter. This primary indicator of China's degree of financial integration tells us how China's opening to external capital flows is progressing compared to overall economic growth. We supplement this assessment with other indicators of China's integration into global financial markets: the balance of cross-border capital flows by category plus net errors and

omissions, the breakdown of inflows and outflows by type, the buying and selling of foreign exchange reserves by China's central bank, the role of foreign buyers in total Chinese mergers and acquisitions, and the share of the Chinese currency in global payments.

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: External Financial Liberalization

Percent share



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

- Our assessment is neutral this quarter. Our primary indicator of gross cross-border flows is almost unchanged at 6.9% (compared to 7% in the previous quarter, and against an average of roughly 14% for the United States and 31% for Japan) and remains well below the 9.2% average in 2015–2016. In other words, China is not becoming more open to capital inflows and outflows.
- Our data make clear that tight capital controls continue to restrict outflows, foreign investment is still significantly stifled by policy constraints despite new promises to open key markets, and the central bank continues to actively intervene in the foreign exchange market.
- Restrictions on capital outflows are likely to remain in place. However, Beijing did take steps to encourage more inflows during the review period by revising the Foreign Direct Investment Law and expanding quotas for foreign portfolio investment inflows.

THIS QUARTER'S NUMBERS

To measure Beijing's progress toward its 2013 Third Plenum reform commitments, we track gross **Cross-Border Capital Flows as a Ratio of GDP**. Our data show that cross-border flows normalized somewhat in 2018 but remain well below levels seen in advanced economies. After ticking up to 7.8% in 1Q2018, the ratio of cross-border capital flows to GDP dropped back to 7% in 2Q2018 and 6.9% in 3Q2018. In 3Q2018, gross cross-border capital flows (inflows plus outflows) were \$231 billion. This is higher than the average quarterly flows

in 2017 (\$189 billion) and similar to levels in 2014–2016 (a quarterly average of \$251 billion).

Most concerning this quarter is that China maintained a modest financial account surplus, despite a sharp depreciation in the renminbi (RMB) during the period, which should have probably resulted in a financial account deficit, all else being equal. This likely results from far-reaching capital controls in place since 2016 that dilute reform objectives. China's non-reserve financial account posted a small surplus of \$14 billion in 3Q2018, mostly due to a \$34 billion surplus in the portfolio securities account (see **Net Capital Flows**). The net "other investment" balance was negative \$20 billion, down from plus \$54 billion in 2Q2018, likely because of new transaction costs imposed on foreign currency hedging by banks, and net direct investment was essentially zero (\$0.07 billion) as inflows and outflows balanced each other out.

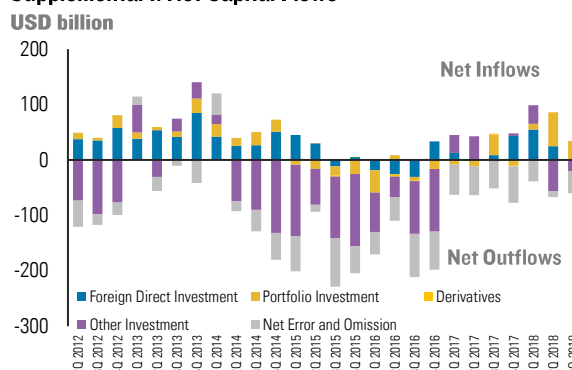
Foreign portfolio investment inflows were volatile, as foreign institutional investors took chances on Chinese investments only opportunistically when short-term factors lined up, a sign of low confidence in long-term liberalization of financial markets. After record inflows of \$65 billion in 2Q2018, foreign portfolio investment dropped to \$43 billion in 3Q2018 (see **Breakdown of Cross-Border Financial Flows**). Foreign sovereign (state-run) buyers such as the Russian central bank, rather than private institutional investors, drove some of these inflows.

After several strong quarters, foreign direct investment inflows also dropped, to just \$25 billion (from a peak of \$80 billion in 4Q2017), another sign of short-term financial considerations at work rather than optimism about new market opportunities. Relatedly, after a brief rebound earlier in the year, the share of foreign buyers in Chinese M&A activity edged down over the past two quarters, showing that recent liberalization steps (such as lower equity limits and joint venture requirements in certain sectors) have not triggered enough enthusiasm to pull foreign investors meaningfully into new acquisitions.

Finally, data make clear that currency intervention persists as a feature of macroeconomic management and that the RMB is far more controlled than other major currencies traded in global financial markets, despite government assurances that the exchange rate will be liberalized. China posted the first official drop in **Foreign Exchange Reserves** since 1Q2017 in the third quarter, totaling \$3 billion. The change in total reserves held by the People's Bank of China (PBOC), China's central bank, as reported in its own data was also

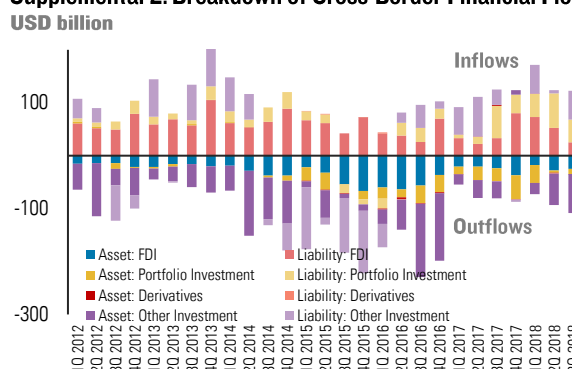
negative for the quarter. These two indicators confirm that the government sold reserves to defend the currency during the review period, as the PBOC resisted depreciation pressure more aggressively starting in August 2018.

Supplemental 1: Net Capital Flows



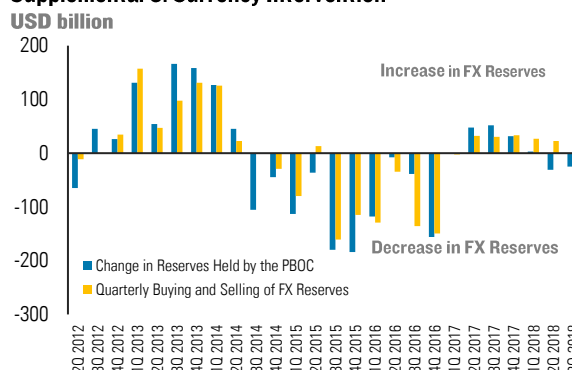
Source: State Administration of Foreign Exchange.

Supplemental 2: Breakdown of Cross-Border Financial Flows



Source: State Administration of Foreign Exchange.

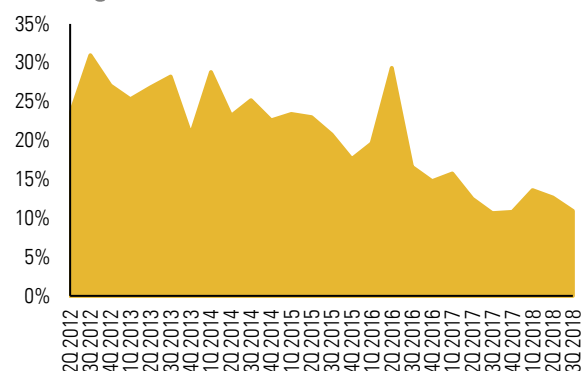
Supplemental 3: Currency Intervention



Source: State Administration for Industry & Commerce, Rhodium Group.

Supplemental 4: Foreign Appetite and Market Access

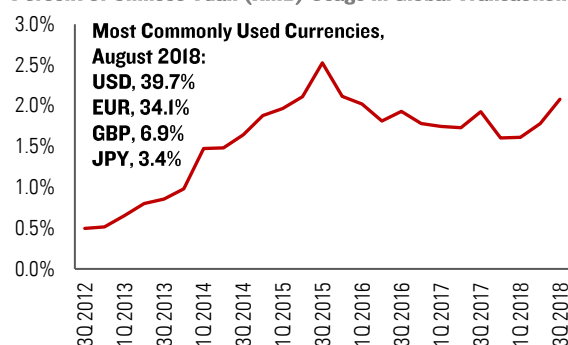
Percentage



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

Supplemental 5: Globalization of China's Currency

Percent of Chinese Yuan (RMB) Usage in Global Transactions



Source: SWIFT.

POLICY ANALYSIS

Beijing's external capital flow policy involves controlling outflows while trying to expand and diversify inflows. Liberalization is happening gradually and mostly on the inbound side. This is unsustainable given China's need for openness to foreign investment and household and corporate diversification into foreign assets.

Controls on outbound capital remained tight against the backdrop of a weakening RMB and slowing domestic growth – both of which could promote capital flight. China's currency depreciated significantly against the U.S. dollar and other currencies starting in June, and officials are guiding interest rates lower to stimulate the economy. With tighter monetary policy and higher rates in the United States and elsewhere, conditions are ripe for capital outflows and pressure on China's balance of payments. The government defied expectations of a relaxation in outbound investment controls and maintained a tight grip throughout 2018. In early

October, China reportedly started to suspend approvals of the Qualified Domestic Limited Partnership (QDLP) investment scheme, in order to control overseas investments. In late October, China tightened scrutiny of overseas investments by financial institutions using state-owned assets and imposed stronger reviews of the structure, funding sources, and investment targets of these companies.

On the inbound side, Beijing released new policies to improve market access and attract foreign direct investment. Most of these are not new ideas, but an acceleration of existing processes and symbolic steps. It is apparent that growing international pressure, particularly from the United States, resulted in measures to improve foreign market access. China demonstrated new willingness to implement previously announced foreign investment liberalization, especially in financial services and autos. For example, in 4Q2018 the China Securities Regulatory Commission approved UBS's application to hold a majority stake in its China securities joint venture, making UBS the first foreign-controlled brokerage in China. Tesla recently broke ground on its Shanghai plant, the first wholly foreign-owned auto factory in China. In addition, Beijing promised better intellectual property (IP) protection for foreign companies, and on December 26 the National People's Congress reviewed a new draft Foreign Investment Law, which will create a new FDI regime based on pre-establishment national treatment for foreign investors, limited only by a negative list and explicitly prohibiting local governments from requiring foreign investors to transfer technology in exchange for market access. These rhetorical commitments are welcome, but they will have to be implemented.

In regards to portfolio investment policy, Beijing announced in August that foreign investors would be exempt from paying income tax and value-added tax on their onshore bond investments for a three-year period. In September, FTSE Russell announced that it will add China's A-shares to its emerging markets index with a weighting of 5.5% starting in June 2019, and additional announcements of planned inclusions of Chinese assets into global bond and equity indices are expected to follow this year. To facilitate this, the Qualified Foreign Institutional Investor (QFII) program quotas were increased from \$150 billion to \$300 billion. However, this is a symbolic gesture, as the State Administration of Foreign Exchange (SAFE) had not allocated individual quotas approaching the previous \$150 billion ceiling: the move itself will permit more inflows only if these firm-specific limits are adjusted.

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 City 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 behind 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, the war on pollution was reinforced by a revised Environmental Pollution Law that increased penalties for polluters and integrated 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 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.

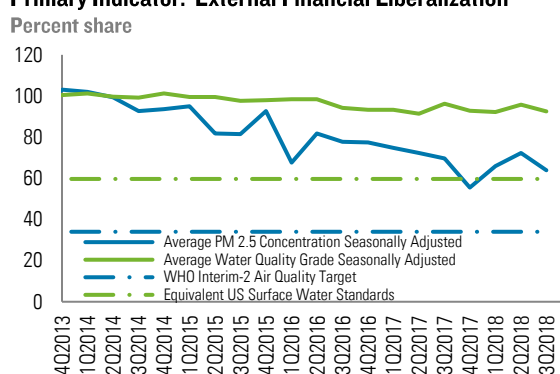
- The State Council created a new Ministry of Ecology and Environment (MEE) in March 2018, consolidating scattered pollution enforcement and environmental powers from seven agencies. The previous Ministry of Environmental Protection had been sharply criticized even by domestic observers for feeble policy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

METHODOLOGY

To gauge environmental reform progress, we track measures of air and water pollution. For air quality, we focus on small particulate matter of 2.5 microns or less (PM 2.5), which is linked to adverse health effects and for which the World Health Organization (WHO) issues pollution guidelines. For water, we monitor the surface water quality of China's freshwater system. Lower levels in our air and water indices indicate improved environmental conditions. We seasonally adjust these indicators to account for annual weather patterns and energy consumption changes. Changes in these factors may also reflect developments in non-environmental areas, such as a macroeconomic slowdown or industry consolidation. To supplement our analysis, we examine China's alternative energy development, including sales of new energy vehicles (NEVs) and non-fossil-fuel electricity generation. We also track wind curtailment, the electricity lost when power operators restrict how much is transmitted from wind turbines to the power grid.

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: External Financial Liberalization



Source: U.S. Department of State Air Quality Monitoring Program, China National Environmental Monitoring Center.

- There was a modest and potentially temporary improvement in environmental performance, an upgrade from last quarter's neutral assessment.
- Both air and water quality indices improved, but progress was not uniform: Beijing City's large improvement in air quality was an outlier, and

modest improvements in water quality likely resulted from declining industrial activity, meaning conditions may deteriorate if the government uses stimulus to boost heavy industrial growth.

- Beijing invigorated environmental enforcement measures, including new soil protection laws and renewed pressure on local governments to decrease pollution levels. However, authorities simultaneously relaxed some winter pollution targets, reflecting a continuous struggle to balance environmental goals against ensuring rapid economic growth.

THIS QUARTER'S NUMBERS

In 3Q2018, our average airborne particulate pollution (PM 2.5) index decreased by 5.6% from 2Q2018, indicating improved air quality. We attribute most of this improvement to air quality changes in the city of Beijing, where PM 2.5 levels improved by 16% from the previous quarter. Our index controls for seasonality appear to corroborate media reports from this summer touting Beijing's visibly "blue[er] skies," after coal plants were replaced with natural gas. July 2018's PM 2.5 rating for Beijing was one of the lowest observed since 2008. At the same time, the other four cities we monitor showed mixed performance. Chengdu and Shenyang saw modest pollution decreases, by 1.7% and 4.9%, respectively, while pollution in Guangzhou and Shanghai slightly increased. Such volatile pollution numbers suggest clean air progress in China is far from sustained or uniform.

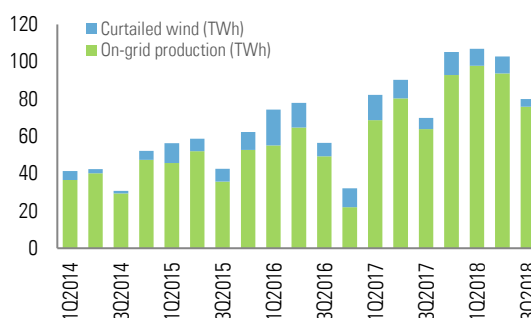
The water quality index improved after a decline in 2Q2018. Water quality increased 3.3% from the previous quarter, though changes in availability of monthly and weekly pollution data throughout the survey period limit the direct utility of quarter-on-quarter (qoq) comparisons. Given that China's water quality closely tracks industrial production, the improvement is likely related to reduced industrial output during the review period. Industrial value-added declined to its lowest levels since 2016 amid a broader growth slowdown. Moreover, improvements in water quality were not uniformly distributed: pollution in the Pearl and Yangtze river basins deteriorated even as the overall index improved.

After making capacity additions throughout 2017, China is using its wind power assets more efficiently. In 3Q2018, **Wind Energy Curtailment**, essentially meaning the amount of wind power wasted because it cannot be transmitted to the electricity grid, dropped to 5% of wind power generation. This represents the second-lowest mark in our dataset since 2013. China's electric vehicle market also continues to expand. While overall auto sales declined in 3Q2018, **Sales of NEVs** as a

percentage of all vehicles sold reached 4.8% in the review period, an increase of nearly 1 percentage point from the previous quarter and a new quarterly high.

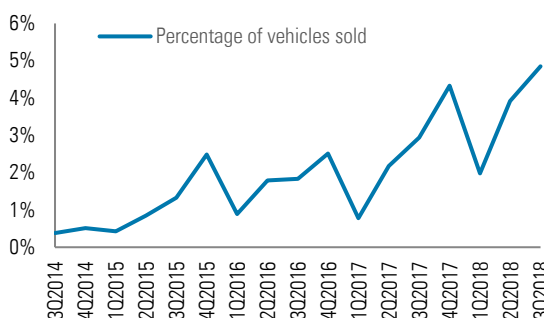
Non-Fossil Fuel Electricity Generation nominally increased by 1 percentage point qoq to 29% of all electricity generation in 3Q2018. However, seasonal adjustment reveals that non-fossil-fuel generation was seasonally low. Our measurement of the amount of electricity generated from non-fossil sources decreased by 7.8% from 2Q2018 to 3Q2018, marking the third consecutive quarterly decline. This reinforces our view that increases in renewable energy generation are being offset by larger increases in overall electricity demand, forcing energy suppliers to use coal power to make up the difference (see our **Fall 2018** edition). As new renewables installation fails to keep pace with increasing electricity demand, coal-fired power will remain ingrained in China's energy mix.

Supplemental I: Wind Energy Curtailment Terawatt hours (TWh)



Source: National Energy Administration, Rhodium Group.

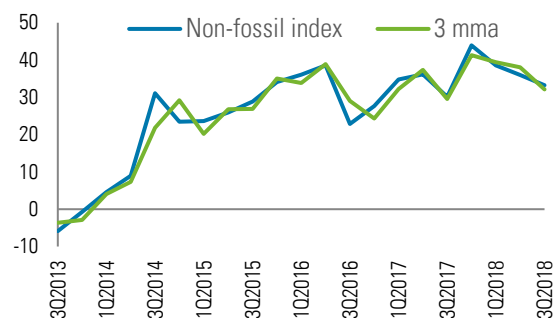
Supplemental 2: Sale of New Energy Vehicles Percent



Source: China Association of Automobile Manufacturers

Supplemental 3: Non-Fossil Generation

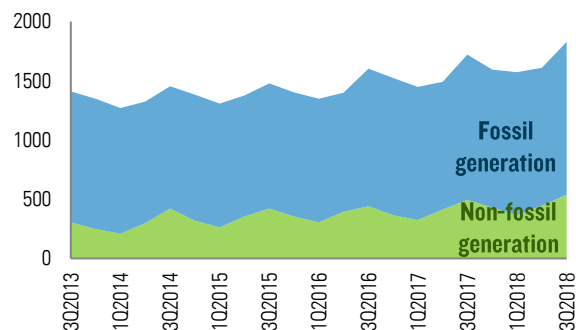
Index (April 2012 = 0)



Source: National Bureau of Statistics.

Supplemental 4: Overall Electricity Generation

Terawatt hours (TWh)



Source: China Electricity Council.

POLICY ANALYSIS

More aggressive policy enforcement was critical in reducing air pollution throughout the review period, but the prospects of sustained air quality action are uncertain as winter approaches and annual heating needs spike. This is a concern as the central government gives more leeway to local officials to set environmental and production targets, while it focuses more on pro-growth measures. During the winter months, enforcement will likely soften from the rigorous measures enforced in winter 2017–2018. On September 27, the Ministry of Ecology and Environment (MEE) announced that it would curtail mandatory winter production cuts in heavy polluting industries like steel and plastics. In the initial draft plan from August, the MEE had suggested northern cities might face cuts of up to 50% of production capacity in its final winter antipollution plan. This represents a partial relaxation of the pollution cuts in the Jing-Jin-Ji region (Beijing-Tianjin-Hebei) that we discussed last quarter, threatening to contravene summer air quality improvements. While the draft plan aimed to reduce the number of winter high air pollution (PM_{2.5}) days by 5% from last year, new directives lower the target to 3%.

This represents an even more drastic reduction from the 15% target rumored to be under consideration in August. Early reports from November and December suggest that smog levels increased in Northern China, in line with typical seasonal patterns.

New soil protection laws enacted August 31 will require authorities to set national soil pollution standards and conduct regular, publicly available soil examinations. China's polluted soil remains a threat to human health and agricultural production, with a 2014 government report revealing that nearly 20% of China's farmland is contaminated with chemicals, improperly disposed waste, and heavy metals. This makes soil pollution a threat not just to local residents' health but also to national food security. By policing the soil, the new measures could also help cut down on water contamination via runoff. The new law specifically grants local governments enforcement responsibility. However, long-term viability will depend on funding; while the law stipulates central and provincial governments will establish pollution cleanup funds when no party responsible for the pollution can be identified, details are limited and a funding source has not been identified.

The central government also continued to press for stronger local environmental inspections and enforcement, consistent with actions during the last review period. In its report on the latest round of provincial environmental inspections issued on September 28, the MEE reported that industrial compliance with environmental inspection rounds was improving, with 60% of cited violations corrected within weeks. However, these reports should be interpreted with caution. While the enforcement push is real, many of the corrective measures are focused on meeting short-term environmental targets (such as shutting down a single noncompliant factory) rather than long-term efforts (such as industry-wide water pollution enforcement). As the campaign continues, more pushback is possible from local officials concerned with offsetting the slowing economy.

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 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 to 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 into the foreign exchange markets. After a poorly communicated adjustment to the currency's daily fixing mechanism produced a shock depreciation in August 2015, yuan movements have become much more volatile. While markets have a freer hand to adjust the yuan'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 to 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.

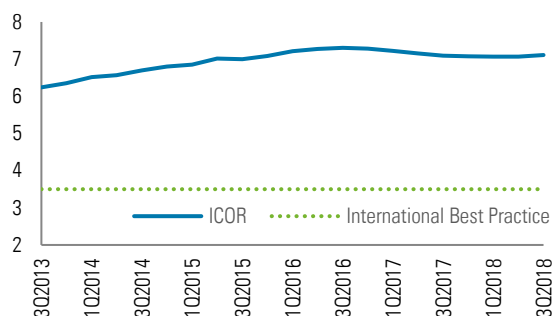
METHODOLOGY

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

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Incremental Capital Output Ratio

4qma, ratio value



Source: National Bureau of Statistics, Rhodium Group.

- Our assessment is neutral this quarter. Our primary indicator of capital efficiency held at 7.1, showing China's financial system is far less efficient than those in other developed economies.
- Beijing's deleveraging campaign within China's financial system continued during the review period. This reduced financial risks on the funding side of banks' balance sheets, but it increased economic risks as less credit flowed to firms and households.
- Money market rates generally fell in 3Q2018, which reduced the attractiveness of shadow banking assets, while a rising proportion of financing was extended formally as loans – all consistent with reform objectives.

THIS QUARTER'S NUMBERS

The primary indicator, the quarterly incremental capital output ratio (QuICOR), remained stable at 7.1 this quarter, well above the 3.5 international standard for capital efficiency. This indicates that even though China's economy and financial system are experiencing

slower growth at present, credit is not being allocated more efficiently in terms of generating economic activity. The more efficient private sector is typically squeezed in any slowdown in aggregate credit in China, because state-owned firms have more fixed assets to pledge as collateral and tend to maintain closer political access to state-owned banks. As a result, private sector access to financing has suffered over the past year of deleveraging as overall credit has slowed.

Overall credit growth continued to slow (see **Growth in Credit**), consistent with Beijing's deleveraging campaign to reduce systemic risks within the financial system. Formally, the PBOC's measure of credit growth, total social financing (TSF), fell to 10.6% year-on-year (yoy) in 3Q2018 from 11.1% in 2Q2018 and dropped sharply from 16.6% yoy in 4Q2016. In reality, the slowdown in credit growth was probably sharper than that, as the central bank revised measures of TSF growth that had the effect of boosting the headline data. Bank assets, a broader measure of credit growth, rose by only 7.3% yoy in 3Q2018. The slowdown in credit growth is an essential part of financial reform, as China's financial system has grown much faster than the real economy since the global financial crisis – an untenable situation that generated considerable financial risk.

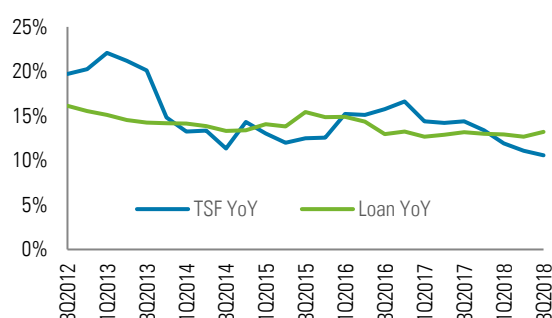
Money market rates declined significantly during the review period, which reduced the attractiveness of informal, or shadow banking, investments. As a result, more financing was extended in the form of loans, which increased from 12.7% to 13.2% in 3Q2018, and corporate bond issuance remained strong as well, despite rising credit risks in that market. Offering rates on Yu'e Bao investments, the country's biggest money market fund that we use as a benchmark in our indicator of financial repression (see **Return on Savings**), dropped to 3.29% in 3Q2018, down from 3.87% the previous quarter. Because most of Yu'e Bao's funds are reinvested into China's money markets, lower interbank money market rates tend to discourage purchases of wealth management products and other alternatives to more stable deposits.

Money market rates for the broader interbank market that includes nonbank financial institutions and shadow banks (see **Interbank Lending Rates**) nearly converged with rates for banks alone, indicating less demand for credit from riskier institutions. One of the final steps toward interest rate reform is the convergence of money market rates (which need to fall) and deposit rates (which need to rise) to channel financing for banks back into safer, deposit-dominated forms. However, deposit rates did not increase during the review period.

Foreign investors' participation in China's financial markets remains extremely low but increased throughout the first half of 2018, and this trend extended in 3Q2018, with the proportion of foreign ownership in China's domestic bond market up to 2.27% in 3Q2018 from 2.18% in 2Q2018. Foreign ownership of China's government bonds in particular has surged, reaching more than 8% of the total market, with some purchases anticipating China's inclusion in global bond indices in the years to come. In October and November 2018, however, foreign bond purchases reversed sharply, most likely due to expectations of currency depreciation.

Supplemental 1: Growth in Credit

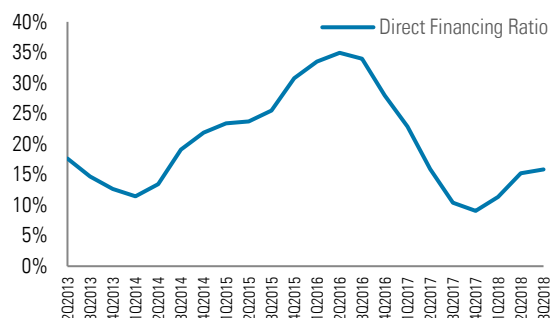
Percent



Source: People's Bank of China.

Supplemental 2: Direct Financing Ratio

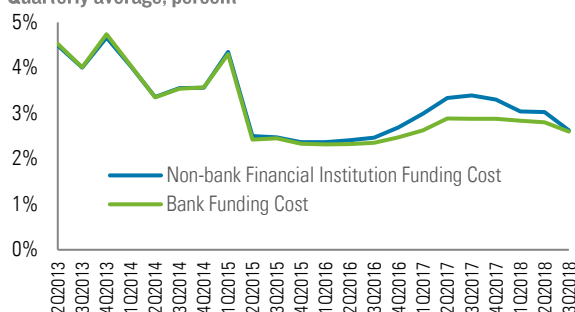
4qma, percent



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

Supplemental 3: Interbank Lending Rates

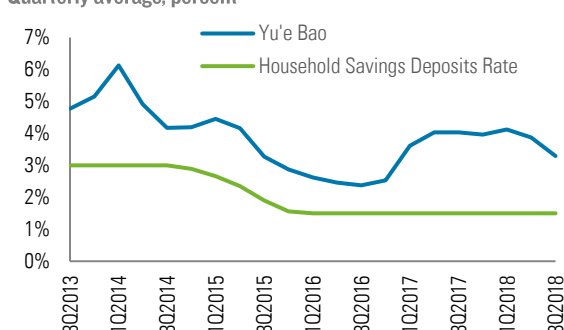
Quarterly average, percent



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

Supplemental 4: Return on Savings

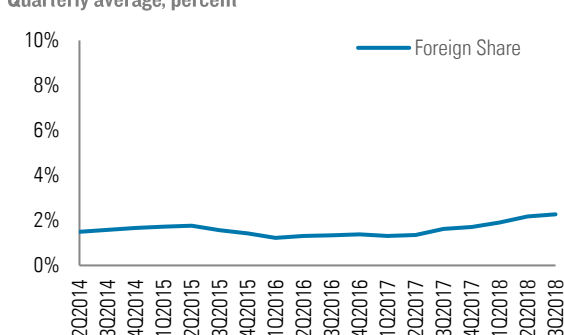
Quarterly average, percent



Source: The People's Bank of China.

Supplemental 5: Foreign Held Bonds

Quarterly average, percent



Source: ChinaBond, Shanghai Clearing House, Rhodium Group.

POLICY ANALYSIS

Beijing took significant actions to reduce financial risks over the past two years but took fewer steps to reform the financial system or improve its efficiency. The results of that approach are apparent: as credit growth slowed in 2018, so did the economy. Nonetheless, slowing credit growth is an essential first step in any reform program, and Beijing's efforts successfully moved China's economy closer to an outright reduction in leverage, with credit growth rates very close to nominal GDP growth.

Now, with the economy slowing, Beijing may be tempted to abandon the deleveraging effort in favor of a traditional stimulus. The key area to watch as an indicator of Beijing's intentions is the enhanced regulatory structure that controlled informal financing growth successfully so far this year. All signs are that this new institutional structure, along with some critical asset management product rules implemented in May 2018, will remain in place, even if monetary easing continues in an attempt to stabilize growth.

Monetary-easing steps – including four adjustments to banks' required reserve ratios (RRR) and guidance of money market rates lower in 2018, and an additional RRR cut in January 2019 – do not necessarily indicate that the deleveraging campaign is ending. Lower money market rates are essential to reduce the attraction of shadow banking assets, although they must be paired with tighter regulations at the same time. Ultimately, the central bank's final stage of interest rate reform requires the convergence of money market rates with formal bank deposit rates, to reduce the regulatory arbitrage opportunities giving rise to shadow banking and financial risks. So far, money market rates have declined, but deposit rates have not fully converged.

A broader concern is the inability of policy measures to improve the efficiency of the financial system operating at a slower pace of credit growth. Funding for more efficient and dynamic private sector firms remained a key problem in 2018, as the slowdown in credit growth privileged state firms. One attempt to solve that via diktat – banking regulator Guo Shuqing's November 2018 comments that 50% of new loans should go to private businesses over the next three years – was widely dismissed as unworkable, and potentially risky, given banks' inability to evaluate credit risk systematically among private firms. More fundamental issues limiting private sector lending include long-standing institutional preferences for lending to state-owned enterprises, limited access to collateral, and the lack of sufficient net interest margins in private lending to compensate for the risks; interest rate cuts focused on reducing bank funding costs would assist this process.

Foreign bond market participation slowed in late 2018 because of the looming threat of yuan depreciation as the central bank aggressively defended the yuan during a period of U.S.-China negotiations at the G20 summit in Buenos Aires in late November. Should the yuan weaken to a more attractive valuation, this would likely extend 2018's aggregate surge in foreign ownership in China's government bond market, given continued anticipation of China's inclusion in global bond indices in the years ahead.

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 fiscal reform is critical, and that it has a long way to go. The 2013 Third Plenum promised to close the gap between the central government's expenditure directives to local governments 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 “bond swap” program to compel local governments to swap all non-bond 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. Only 256.5 billion RMB (\$37 billion) of this remains to be swapped as of October 2018. The program improved local fiscal transparency and reduced interest burdens for local governments.
- The central government initiated value-added tax (VAT) reform in 2012 in pilot form and officially rolled out VAT nationwide in 2016. The VAT replaced China's complex business tax with a more simplified scheme meant to cut corporate tax burdens. In practice, the VAT decreased net local government tax revenue, 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 3 to 5 years. While the exact amount of local government implicit debt is unknown, credible estimates put it between 30 and 45 trillion RMB (\$4.3–6.5 trillion).

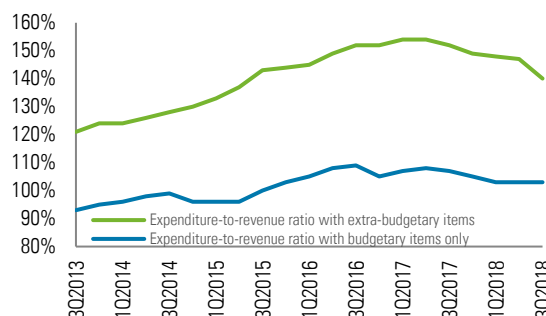
METHODOLOGY

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 “extra-budgetary,” expenses and revenues in green – thus covering the range of estimates. The higher the expenditure-to-revenue ratio, the more concerning the side effects, including local government debt burdens. Our supplemental fiscal indicators include local financing sources, the national official and augmented fiscal position, the move from indirect to direct taxes, and the share of expenditures on public goods.

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Local Governments Expenditure-to-Revenue Ratio

4qma, percent



Source: National Bureau of Statistics, Rhodium Group.

- We slightly improve our assessment of fiscal reform but remain negative overall: fiscal conditions are deteriorating and policy change is insufficient to reverse that.
- A surge in local government special revenue bond issuance in the third quarter of 2018 drove the largest quarterly improvement in our primary indicator in six years.
- Policy developments were not encouraging: the State Council allowed local governments to renegotiate or restructure implicit debt, despite a requirement from earlier in 2018 that these debts be repaid, reinforcing moral hazard problems.

THIS QUARTER'S NUMBERS

Our primary indicator, the augmented **Local Expenditure-to-Revenue Ratio**, saw the largest quarterly improvement in our data sample, with the ratio declining from 147% in 2Q2018 to 140% in 3Q2018. This means that provincial governments spent 40% more than the revenue they collected in the third

quarter, even after accounting for some off-budget financing activities. While local fiscal conditions are still deteriorating, they are deteriorating at a slower pace than in our last review.

There were signs of improvement in both local revenues and expenditures. The primary cause driving the lower local expenditure-to-revenue ratio (i.e., fiscal improvement) was a spike in local government special revenue bond issuance totaling RMB 1.68 trillion (\$243 billion) for the quarter, up from RMB 0.33 trillion (\$47.8 billion) in 2Q2018 (see **Sources of Local Government Financing**). Issuance of these bonds is highly seasonal, so the ratio's decline is likely to be temporary. Overall, the increasing reliance upon special revenue bonds is a long-term positive for local governments' fiscal positions.

Special revenue bonds can serve as a long-term supplemental funding channel for local governments, improving overall local government fiscal sustainability. Beijing is expected to boost full-year special revenue bond issuance in 2019, probably surpassing RMB 2 trillion (\$290 billion). Compared to borrowing by local government financing vehicles (LGFVs), special revenue bonds bear lower interest rates and improve the transparency of local government balance sheets. Unlike general government bonds repaid from fiscal coffers, special revenue bonds are used to finance income-generating projects specifically, with repayment secured by cash flows from the projects. This is one reason the bonds are more attractive to investors. These special revenue bonds may become the foundation of a Chinese version of a municipal bond market in the future.

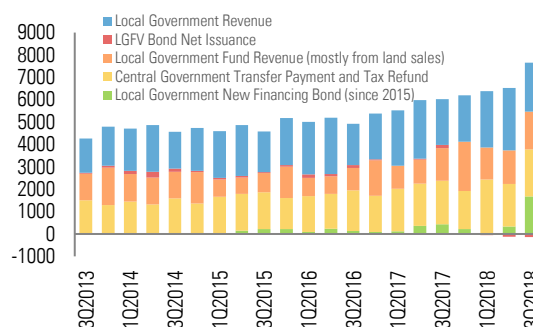
Issuance of special revenue bonds will drop in 4Q2018 and 1Q2019, as quotas are only approved at the March National People's Congress meeting. In 2018, issuance was particularly strong in 3Q because of complications related to the sunset of the three-year "bond swap" program in August, which had allowed local governments to replace a fixed amount of higher-interest debt with lower-cost bond financing. Local governments mostly sold these bond swaps in the first half of 2018 and only turned to selling special revenue bonds starting in August. Consequently, the primary indicator improved considerably in 3Q2018, but this probably will not continue into 4Q2018. This explains why our assessment of fiscal conditions is only modestly more positive than last quarter despite the substantial improvement in the indicator.

In terms of local government spending, infrastructure investment by LGFVs declined further in 3Q2018, by

10.7% year-on-year, larger than the 4.5% drop in 2Q2018. This was in line with official National Bureau of Statistics (NBS) data also published during the review period that showed record-low infrastructure investment growth of only 3.3% in the first nine months of 2018. Infrastructure investment showed signs of rebounding in October 2018 following a State Council circular permitting restructuring of local government debt (see **Policy Analysis** below), freeing up resources for additional spending.

Another worrying sign for local fiscal conditions is that fiscal revenue growth is flagging, as revenue from Beijing's supplementary fiscal account, the "fund budget" (heavily driven by local government land sales) was only up by 16.3% in 3Q2018, compared to 40.5% in 2Q2018. Property developers have a full year to pay localities for land purchases, so most of the growth in land sales revenue reflects purchases made in 2017, as most proceeds are paid close to the deadline. The slowdown suggests land sales were already weakening in the second half of 2017 and continued declining in 2018. This is highly problematic for local government fiscal conditions given their high reliance on land transfer fees as a source of revenue. Local governments faced strong pressure to repay implicit debt earlier in 2018, and they redoubled efforts to collect land sales revenue. As a result, revenue growth overall will likely weaken in the remaining months of 2018 and into 2019.

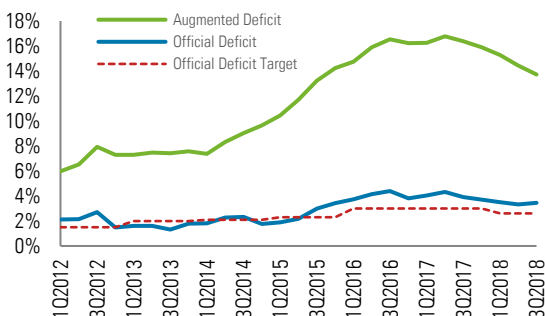
Supplemental I: Sources of Local Government Financing
RMB billions



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

Supplemental 2: Fiscal Deficit Measures

4qma, percent



Source: Ministry of Finance, Rhodium Group.

Supplemental 3: Direct Taxation Ratio

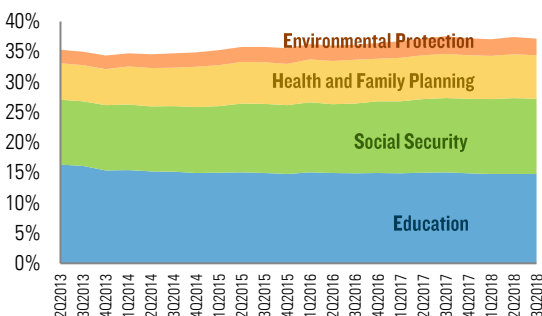
4qma, percent



Source: Ministry of Finance, Rhodium Group.

Supplemental 4: Government Social Expenditures

4qma, percent



Source: Ministry of Finance, Rhodium Group.

POLICY ANALYSIS

Reform of the central-local fiscal system was a key focus for Chinese policymakers in the previous quarter, given the rising risk of defaults from local government debt. The most significant policy change in this review period was allowing localities to extend and restructure some of their contingent liabilities rather than repay them directly, with the shift announced in October in a State Council circular. The purpose of this adjustment was to stabilize weakening infrastructure investment and

overall economic growth. While deleveraging worked to reduce some of the risks within the financial system, it stalled growth in the process.

While acting to stabilize the economy under the pressure of deleveraging and trade tensions is an understandable response from Beijing, the adjustment in local debt management reinforces moral hazard by strengthening market expectations of implicit guarantees for LGFVs and SOEs. Yields on LGFV bonds dipped below those of non-LGFV corporate bonds following the move, after LGFV bonds had traded at higher yields for most of the first half of 2018. Confidence in LGFV implicit guarantees was shaken since last year by multiple bond defaults – which was a positive story because financial markets were finally starting to price credit risk more accurately. Now market expectations that the government will bail out LGFVs have returned, to the detriment of financial market reform.

Other fiscal policy adjustments included new individual income tax thresholds and exemptions beginning October 1, a move to shore up household consumption. The central government also frontloaded 2019 fiscal year transfers to debt-strapped localities totaling RMB 2.1 trillion (\$304 billion), revealing the severity of local funding stress.

The outlook for fiscal policy reforms in 2019 is somewhat brighter. Beijing is expected to merge the current value-added tax (VAT) structure from three rates to two, and corporate income taxes could also be cut, which would both simplify the overall tax structure and cut the central government's proportion of revenue collection. Contributions to social security pension funds are now being enforced by the State Administration of Taxation, which brings some short-term pain to companies but is a positive sign for longer-term fiscal reform as Beijing can obtain a more accurate picture of overall revenue collection, improving transparency.

Most importantly, the pressure from local government debt is likely to produce some relaxation in central government control of local fiscal autonomy. This centralization of control has been a key factor behind the fundamental mismatch in central-local fiscal policy, because the central government mandates local governments to spend well more than the revenue they take in. Over the past six years, Beijing has replaced business taxes – where revenue accrued to localities – with VAT, where revenue is shared between central and local governments (temporarily). The consequence has been a rapid accumulation of local government debt as

localities tried to manage spending obligations and maintain economic growth.

Now, with local government debt levels far too high, some reversal and relaxation of Beijing's control are probable. Implementation of a property tax may still be a difficult step amid a slowing property market, but it remains one of the most promising options for local governments to generate revenues. Some revisions of the relevant laws related to property taxes are expected to begin this year, although implementation would happen only in 2020 at the earliest. With China's home ownership rates at more than 80%, collecting taxes on existing homes is a more promising channel for local governments to obtain a sustainable new source of revenue than trying to sell more land to developers.

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 often succeeded with limited government policy support. In other cases, innovation interventions have helped, at least for a while.

- The 2013 Third Plenum released a series of decisions aiming at improving the innovation environment in China. Compared with previous innovation strategies, the Third Plenum placed a greater emphasis on market forces, calling for “market-based technology innovation mechanisms” while announcing that the “market is to play a key part in determining innovation programs and allocation of funds and assessing results, and administrative dominance is to be abolished.”
- In May 2015, China officially launched Made in China 2025 (MC2025), a 10-year strategic plan for achieving new levels of innovation in emerging sectors. The MC2025 agenda diluted the 2013 Third Plenum’s emphasis on market mechanisms with more elements of central planning. The blueprint set specific performance targets for 10 key industries in proportions of domestic content and domestic control of intellectual property. An associated implementation roadmap 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 in photovoltaic (PV) power generation and new energy vehicles (NEV).
- In March 2018, the U.S. Section 301 Investigation 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.

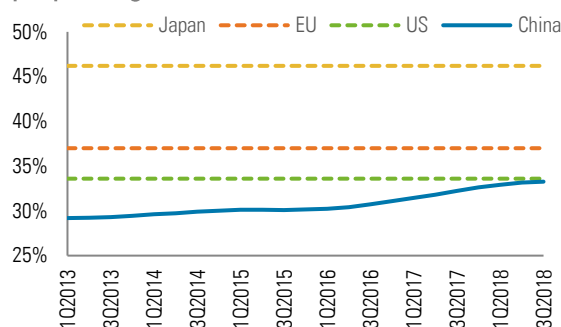
METHODOLOGY

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 presently publish all IVA data details, we use an indirect approach to do this. Our supplemental gauges look at value-added growth rates in specific industries, China’s performance compared with that of advanced economies in specific industries, China’s trade competitiveness in innovative products, and two-way payments flows for the use of intellectual property.

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Innovation Industry Share in Industrial Value-added

4qma, percentage



Source: National Bureau of Statistics, Rhodium Group.

- Our assessment of China’s innovation progress is slightly positive, the same as last quarter. The primary indicator, which measures the weight of innovative industries in China’s economy, continues to increase albeit at a slower pace than in our last review: higher-innovation industries are outgrowing others.
- Our data tell two interesting stories in this review period: that U.S. trade action against China has had minimal impact on its innovation goals so far, and relatedly, that a heavier concentration of foreign firms in innovative sectors is helping China’s higher-end sectors outperform a slowing economy.
- However, upcoming investment and export restrictions targeting Chinese companies could negatively impact China’s innovation drive.

THIS QUARTER'S NUMBERS

Innovative Industry Share in Industrial Value-added, our primary indicator, slightly increased from 33.2% to 33.3% this quarter. This is the 11th quarter of consecutive growth for this indicator, and it shows that innovative industries continue to play a larger role in China's industrial mix.

While China's innovative industries are outperforming a slowing economy, the pace at which they are growing vis-à-vis other sectors slowed modestly in this review period to 10 basis points (bps), down from 25 bps in 2Q2018 (see **Volatility in Innovative Industry**). This occurred for two reasons: first, because the non-auto transportation equipment sector (i.e., rail, ships, aircraft) did not grow during the review period. Infrastructure investment grew by only 3.3% year-on-year (yoy) in the first nine months of 2018 – a dramatic drop from around 20% average growth in 2017 (though we expect this to turn around in 2019). Second, many high-polluting producers (i.e., steel mills) front-loaded production, anticipating government production curbs during the winter to improve air quality. As a result, the “non-innovative” share of industrial activity increased. We expect these effects to last into 4Q2018. Still, China is on pace to catch up to the U.S. level of IVA from innovative industries over the next few quarters.

One of the reasons for this outperformance of innovative industries is the role that foreign firms play in China's high-tech sectors. Of note, our primary indicator captures the aggregate output of both domestic and foreign companies operating in China. And official statistics show that foreign investments play a major role in driving high value-added industrial output. For example, foreign-funded (including Hong Kong, Macau, and Taiwan) businesses accounted for 77% of China's total high-tech exports in 2016 (the most recent year of available data).

This significant presence of foreign firms in China's innovative industries, and their lower dependence on volatile local financing sources, has lately provided a crucial buffer against the consequences of deleveraging, which tightened credit conditions for many sectors. For example, the industry category “communication, computer & electronics,” which accounts for 27% of total innovative-industry value-added as of 3Q2018, grew at 13.2% yoy, up from 13% in 2Q2018 (see **Industrial Value-Added Growth Rates**). This was more than double the industrial average of 6% in 3Q2018. This subsector also has the largest share of foreign-funded company participation in high-tech industries: foreign firms accounted for 44% of total assets in communication and

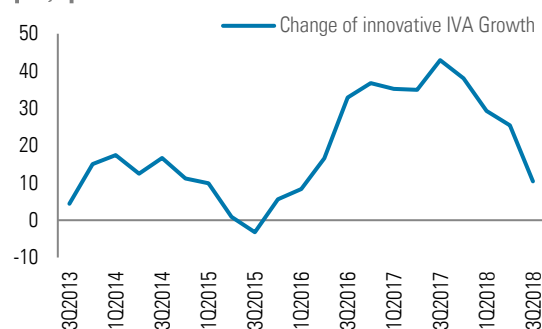
electronics manufacturing, and 68% of total assets in computer and office equipment manufacturing as of 2016.

Foreign high-tech companies are not immune from China's economic slowdown, of course, and the past quarter saw increased uncertainty about the outlook for the Chinese consumer in particular. For example, consumer electronics giant Apple expressed concerns about the Chinese market in early January 2019 while issuing a weaker-than-expected earnings report for the fourth quarter of 2018, amplifying market concern about China's economic trajectory.

Another important conclusion in this period is that the Section 301 investigation by the U.S. Trade Representative (USTR), initiated in March 2018, has had minimal impact on China's innovation progress so far. The USTR concluded that China's industrial policies were “unreasonable or discriminatory and burden or restrict U.S. commerce.” The United States imposed a 25% tariff on \$16 billion of Chinese imports that were directly related to MC2025, and a broader set of \$200 billion in imports that were not directly related to China's industrial policy efforts. Yet MC2025 industries grew steadily even after U.S. tariffs became effective in August 2018. Communication, computer, and electronic equipment industries grew at more than twice the industrial average, as noted above. Electric machinery, another industry targeted by the U.S. tariff list, grew by 7.5% in 3Q2018, down somewhat from 9.4% in 2Q2018, but still above the industrial average. We believe the industry is likely to bounce back in the fourth quarter, according to preliminary data from October and November 2018. It still may be too early to see an impact from tariffs; however, these indicators will warrant greater scrutiny going forward.

Supplemental 1: Volatility in Innovative Industry

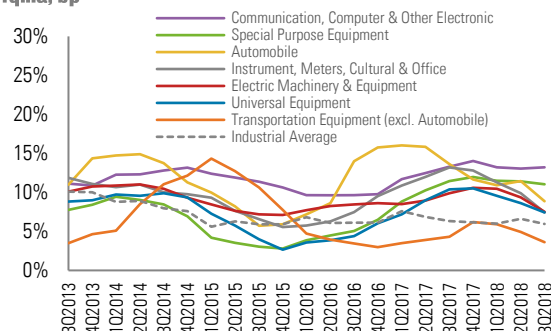
4qma, bp



Source: National Bureau of Statistics, Rhodium Group.

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

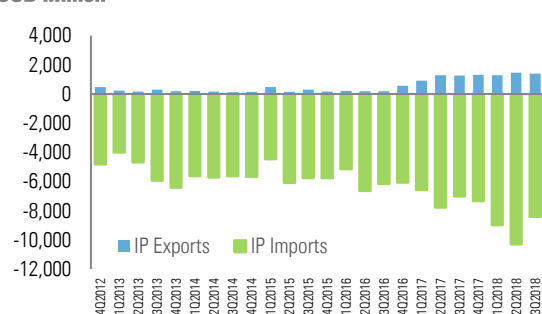
4qma, bp



Source: National Bureau of Statistics, Rhodium Group.

Supplemental 3: Intellectual Property Flows

USD Million



Source: National Bureau of Statistics, Rhodium Group.

POLICY ANALYSIS

The U.S.-China trade war continued to boil in this review period, and China's innovation policy was a central focus of dispute. A key question is whether Beijing will soften its industrial policy ambitions to mitigate the potential for additional punitive trade action from the United States.

On December 6, Premier Li Keqiang held the first meeting of the National Science and Technology Leading Group (STLG). The STLG is perhaps the most prominent government body tasked with managing China's innovation policies. Curiously, the official meeting readout did not mention MC2025, which may have been a deliberate omission. In the days following the meeting, some international media reports speculated that Beijing might be in the process of revising its MC2025 program to address U.S. concerns. There is some evidence supporting this speculation: in recent months, references to MC2025 in government publications and officials' public remarks have almost entirely disappeared.

Some analysts suspect that Beijing is merely rebranding its industrial policies without changing the content. The USTR, for example, updated its Section 301 Report in November 2018, concluding that despite the fact that Beijing seemed to be deliberately downplaying MC2025, "China fundamentally has not altered its acts, policies, and practices related to technology transfer, intellectual property, and innovation, and indeed appears to have taken further unreasonable actions in recent months."

In the absence of material concessions from China on industrial policy, the United States continued to ramp up investment and trade restrictions. On November 19, 2018, the U.S. Department of Commerce issued for comment the draft list of "emerging technologies" that would be subject to expanded export controls, including artificial intelligence (AI) and robotics as well as much else. Beginning on November 10, 2018, the Committee on Foreign Investment in the United States (CFIUS) started requiring reviews of critical technology investments, from aircraft to telephone apparatus manufacturing. These export control and investment screening measures are likely to impact China's innovative industries negatively over the long term, because many Chinese companies depend on U.S. partners to supply core technologies and key components. In addition, the U.S. decision to arrest an executive of Chinese telecommunications giant Huawei marks a more distinct break in the trajectory of commercial relationships between U.S. and Chinese firms. The U.S.-China technology symbiosis of the past three decades is changing, and innovation performance on both sides is likely to suffer during the transition.

A slightly more positive development during the review period occurred on December 4, when Beijing released a memorandum of understanding (MOU) among 38 government agencies related to intellectual property rights (IPR) protection. The MOU called for coordinated government actions against IPR violations. Potential

penalties included denying access to capital markets, as well as restrictions on land supply and transportation facilities. Although the MOU did not have the same legal status as legislation or the binding effect of regulations, it was still a notable step forward because the MOU had actionable rules and buy-in among a broader set of constituencies within the government.

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, up from 36% in 2000, increasing fiscal pressure on local governments to deliver social services while adding huge additional economic growth potential. 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 health care and education.

- In July 2014, Communist Party authorities issued an opinion that called for relaxing the burdensome restraints on individuals who wished to move and 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 bigger cities. Policymakers also planned to set up a nationwide residency permit system to 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 thus gain access to basic social services. The measure softened the division between rural and urban *hukou* and laid the basic foundation for the eventual abolishment of the *hukou* system.
- In August 2016, the State Council recommended fiscal support to incentivize urbanization and provide social services based on the newly established residency permit system. The volume of support and its effectiveness in aiding urbanization are still unclear.
- The State Council announced that it would share more social expenditures with localities at the start of 2019. Local governments have long shouldered a disproportionate share of overall government spending while suffering from weak sources of revenue. This measure should help bridge the gap and shore up funding for important social services.

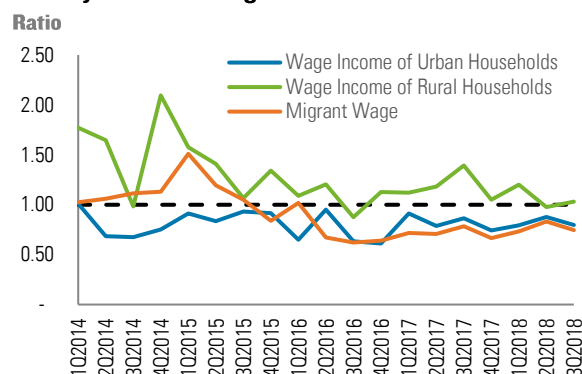
METHODOLOGY

To assess progress in China's labor policy reforms, we chart wage growth for the less-empowered segment of China's workforce, those most likely to bottleneck the country's

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

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Wage Growth Relative to GDP



Source: National Bureau of Statistics, Rhodium Group.

- Our assessment of labor and shared welfare reform is negative—even more so than in the previous quarter—as Beijing did not sustain improvement from the last review period and labor conditions will likely further decline.
- Migrant and urban wage growth weakened compared to GDP, alongside mounting labor shortages across the country, and a decline in government social spending.
- Beijing modestly reduced employee-related expenses for companies, as well as the costs of early education and basic medications for households. These will help improve social welfare at the margins, but they will do little to address the larger sources of labor market dislocation and inequality.

THIS QUARTER'S NUMBERS

Despite several new policies advanced in 3Q2018, our indicators suggest that authorities did not improve labor's share of income in the economy in line with 2013

Third Plenum goals. Growth in migrant wages as a ratio of GDP growth, our primary indicator of Beijing's success in encouraging labor mobility and employment opportunities, declined from 0.83 to 0.75. In other words, migrant worker wage growth was 25% lower than GDP growth in 3Q2018. The wages of urban workers, the largest section of the labor market and particularly important for the health of consumption, were also weak, dropping from 88% to 80% of GDP growth – even in an era of moderating GDP. Stronger rural wages would indicate that policies were helping to equalize the development gap between cities and the countryside. However, rural employment income only saw a small recovery in 3Q2018, which did little to offset the consistent slowdown over the previous six quarters.

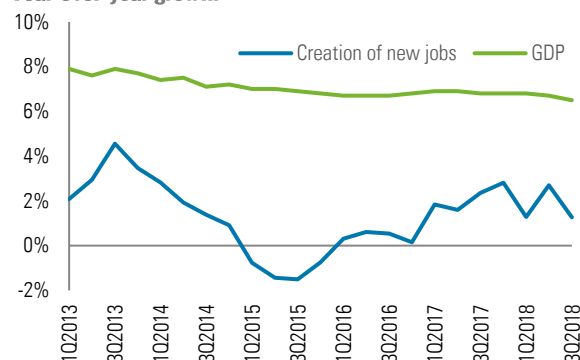
Supplemental indicators suggest a disconnect between job supply and the availability of qualified candidates. New employment continued to grow more slowly than real GDP, with the pickup of 2.7% year-on-year in 2Q2018 declining to 1.3% in 3Q2018 (see **Job Creation**). Weaker employment did not result from a lack of job openings, but rather the inability or unwillingness of applicants to assume those positions. For cities across China, the ratio of job openings to job applicants spiked, with all three regions seeing nearly the highest imbalances on record (see **Labor Demand-Supply Ratio**). In an efficient market, persistent labor shortages should cause wages to rise, and there were tentative signs of improvement in the previous two quarters. The decline in wages in 3Q2018, however, suggests structural problems. There are two likely contributors. The first is *hukou* (household registration) restrictions, which still prevent qualified applicants from relocating to fill new jobs. The second, related contributor, is that candidates in local labor markets lack the skills required for available positions.

Data show that the government is not spending enough to address these challenges, as fiscal expenditures are actually weakening (see **Social Spending**). Government social spending as a percentage of GDP declined in the first half of the year, a trend that continued in 3Q2018. Education spending dropped compared to 3Q2017, a concerning development given the increasing demand for skilled workers. Spending on social security, employment, and health and family planning declined in both year-on-year and quarter-on-quarter terms. Weaker spending is in part due to the ongoing campaign to cut local government and corporate debt, which has also caused companies to lay off workers and reduce wages. The unfortunate result of these two outcomes is that 3Q2018 government assistance was pared down precisely as the need for such assistance grew. The slowdown in transfer income received by urban

households reflects this, growing by the slowest level in five years at 8%. If authorities do not act to bolster government spending, risks to the labor market, consumer spending, and the broader economy will increase.

Supplemental I: New Job Creation

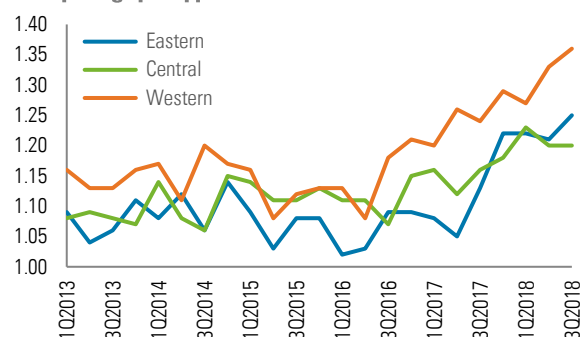
Year-over-year growth



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

Supplemental 2: Labor Demand-Supply Ratio

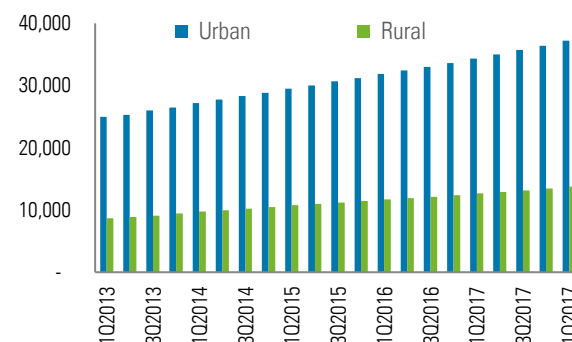
Job openings per applicant



Source: Ministry of Human Resources and Social Security.

Supplemental 3: Rural-Urban Household Income

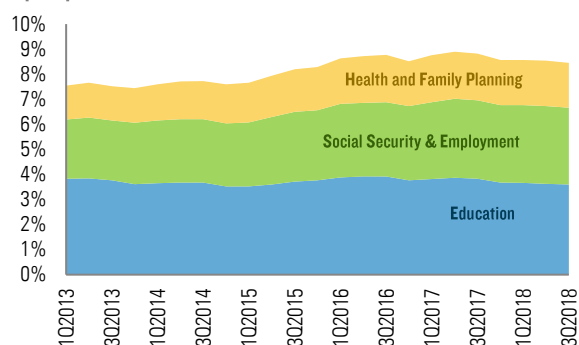
Annualized RMB



Source: National Bureau of Statistics.

Supplemental 4: Government Social Expenditures

4qma, percent



Source: National Bureau of Statistics, Ministry of Finance.

POLICY ANALYSIS

Beijing made only modest changes to labor-related policies, which did not significantly address growing employee-related costs for companies or the affordability and accessibility of important social services. The most important policy development was a State Council announcement on December 5 that would seek to stabilize employment by providing vocational training, subsidizing entrepreneurship, and refunding 50% of funds that companies pay for unemployment insurance. The last measure is meant to ease the growing financial burden on small- and medium-sized firms, which now face a more thorough collection of social security contributions.

Chinese companies are required to pay only 1% of their employees' salaries as unemployment insurance. Other costs are much steeper: contributions for pensions, for example, must equal 19% of salaries. Credible estimates from domestic think tanks argue that government would need to reduce social security contribution costs by 6 to 9 percentage points to offset the impact of enhanced collection methods. However, local governments desperately need more revenue (see [Fiscal Affairs](#)) to make up for the shortfall in social security funds. In the short term, this is an unresolvable dilemma, which is a major factor in our negative assessment. Beijing will have to decide whether to ease the contribution burden on companies, which will allow for stronger employment and wages, or to ensure sufficient funding of the pension system, which will help sustain this program in the long term. The current policy mix prioritizes the latter and, if left unchanged, will weaken labor conditions in 2019.

Ensuring affordable access to early education is vital for both child development and the productivity of China's future labor force. In pursuit of this goal, Beijing issued

preschool regulations aiming to increase the share of kindergartens following government pricing guidance to 80% by 2020 from less than 60% this year. While this policy will likely achieve its goal of reducing tuition costs, it will also limit private fundraising for these schools. It is unclear how policymakers plan to make up the difference in funding, given the declining level of spending on education over the past year.

In another move to lower costs of living, officials approved a plan to centralize the procurement of basic medications. While good intentions may have been behind this move, the policy will more likely have a negative impact on healthcare services. Intervention to improve consumer bargaining power may reduce prices in the short term, but at the long-term expense of the industry's efficiency. The plan will cover 11 cities that account for up to 50% of China's total demand for basic medications, and some medications saw price reductions of up to 90%. The extent of this reduction and central control over the bidding process will likely decrease the willingness of domestic and foreign companies to invest in pharmaceutical markets.

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. Fiscal reform to replace 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.
- 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.

- Rural agricultural land reform is progressing faster than rural nonagricultural land reform: revisions to the Land Management Law, which governs rural residents’ rights to rural nonagricultural land and the scope of lawful land requisition by the government, were released for public comment in May 2017 but have not since come forward for legislative review. Revisions to the Rural Land Contracting Law that enshrines farmers’ rights to transfer agricultural land, in contrast, were reviewed three times in just more than a year by the Standing Committee of the National People’s Congress, passed in December 2018, and took effect on January 1, 2019.

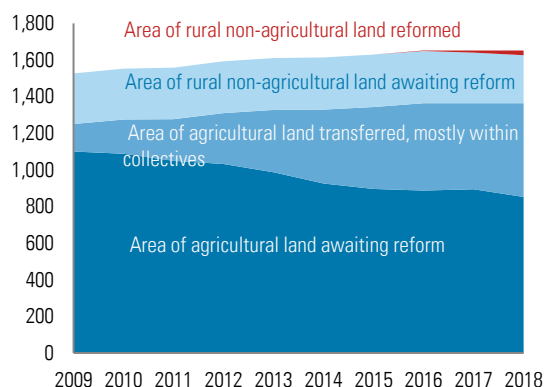
METHODOLOGY

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

Primary Indicator: Land Marketized

Million mu (1 mu ≈ 1/6 acre)



Source: Ministry of Agriculture, Ministry of Land and Resources, Rhodium Group.

- Our assessment of land reform remains negative, just as in our previous review, as insufficient progress is being made toward 2013 Third Plenum goals of

liberalizing China's land markets to improve rural livelihood and promote urbanization.

- Levels of rural nonagricultural land transferred by market means remain minuscule as a percentage of total land potentially available for reform, according to our primary indicator, meaning that China's land markets are still highly inefficient.
- Several promising land-related policy changes have been proposed but are held up in China's byzantine legislative process. Land reform is still not a top priority for Chinese leaders, which means that our indicators are unlikely to improve much in the coming quarters.

THIS QUARTER'S NUMBERS

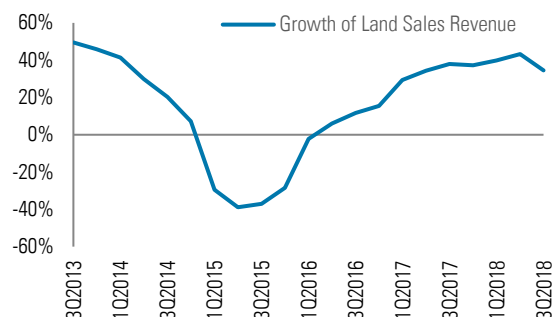
Our primary indicator of land reform shows that the amount of rural nonagricultural land being transferred by market means is still just a small proportion of overall land supply in China. Three pilot programs for rural nonagricultural land reform are underway, two of which are making modest progress. Land requisition pilots – which encourage government land requisitions to be conducted at market prices – saw the fastest progress, with 166,000 mu (27,346 acres) requisitioned by 2Q2018 according to official reports released in August, compared to just 39,000 mu (6,425 acres) by 2Q2017 (for this series, data are only available through 2Q2018). The amount of rural land transferred under a second pilot program, which allows rural households to transfer rural nonagricultural land into urban land markets, also increased modestly to 20,000 mu (3,295 acres) in 2Q2018, up from 16,000 mu (2,636 acres) in 1Q2018. Yet together the total area of rural nonagricultural land involved in these two types of pilots remains extremely limited: less than 1% of land potentially eligible to be “reformed,” or transferred by market means. Moreover, no official data are available on whether government requisitions were conducted at market prices.

Our supplementary indicators reinforce this negative assessment of the current state of land reform. Revenue growth for local governments from land transfers remained quite high at 32% year-on-year (yoy) in September (if down modestly from 35% in June), revealing that those governments have a strong and growing incentive to rely on land transfers for fiscal revenue (see **Land Requisition Financials**). Our indicator of lending to the agricultural sector fell further to 2.5% yoy growth in 3Q2018, from 3.6% in 2Q2018, indicating that rural businesses remain under pressure from tighter credit conditions related to deleveraging efforts. One bright spot in our data this quarter was the fact that rural disposable income growth

strengthened modestly to 8.9%, from 8.7% last quarter, partially owing to higher growth in property-related income. However, the lack of financial support for agricultural commercial activities is a barrier to sustaining this improvement. Moreover, the downtrend we see in rural wage growth discussed in our [Labor and Welfare](#) assessment implies that headwinds to rural disposable income growth are likely to remain.

Supplemental 1: Land Requisition Financials

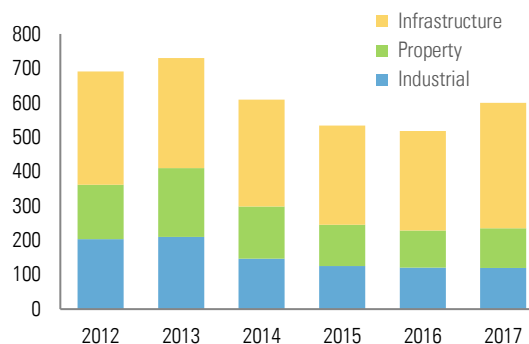
Year-over-year, percent



Source: Ministry of Finance, World Bank, Rhodium Group.

Supplemental 2: Urban Land Supply by Use

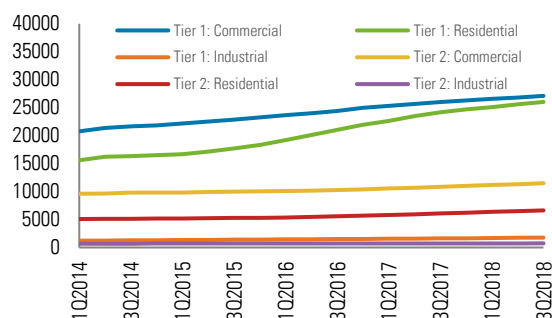
Thousand Ha



Source: Source: Land Statistical Yearbook by Ministry of Land and Resources.

Supplemental 3: Urban Land Prices

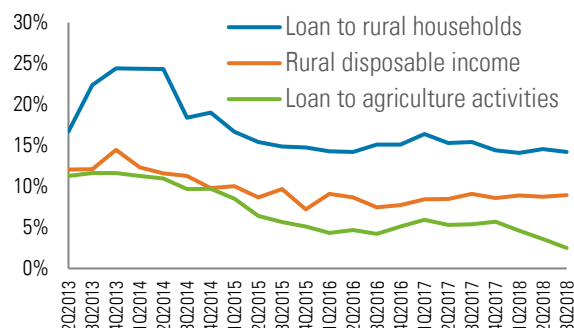
RMB per square meter



Source: Ministry of Land and Resources.

Supplemental 4: Rural Credit

Year-over-year



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

POLICY ANALYSIS

Our negative quarterly score reflects a lack of new breakthroughs in land policy reform during the review period. China's State Council did issue a new [Rural Revitalization Plan](#) for 2018–2022 in late September 2018. The plan reiterated current goals to expand land pilots and accelerate the revision of the Land Management Law, which governs rural residents' rights to rural nonagricultural land, as well as the scope of lawful land requisition by the government. Both objectives, if implemented, would advance land reform in ways aligned with 2013 Third Plenum goals. Yet the 2018–2022 Rural Revitalization Plan also preserves the government's central role in managing land and, hence, runs counter to the 2013 Third Plenum's objective to give more weight to market forces in land allocation. It notably states that local governments will retain their central role in "planning and coordinating land usage" and "allocating land transfer revenue." On the positive side, the plan states that revenue should be used for revitalizing rural areas, but it relies too heavily upon the government, instead of the market, to decide where the associated resources should be allocated.

Policy progress in agricultural land reform continued to outpace progress on rural nonagricultural land reform. The Standing Committee of the National People's Congress (NPC) approved a final draft of an amended Rural Land Contracting Law in December 2018 after reviewing the law's second draft just in October – a rapid process reflecting consensus on needed reform to rural agricultural land. The revised law, which took effect on January 1, 2019, extends farmers' contractual land rights for another 30 years and adds new provisions aiming to protect land use rights, a form of property rights contained within the Rural Revitalization Plan from October 2017 (see our [Spring 2018 Dashboard](#) edition). By facilitating the transfer of rural agricultural land into larger plots, these provisions will help rationalize

agricultural activities and drive greater wealth transfers to rural households. Both are key objectives of the 2013 Third Plenum reform program intended to increase rural income from property-related sources.

In contrast, the review of the revised Land Management Law by the NPC Standing Committee, which was [supposed](#) to take place in August, was further delayed. The law is key to clarifying the rights of rural households and collectives and the scope of government requisitions of rural nonagricultural land. Key obstacles to the law's revision are reportedly linked to inconsistencies within the Constitution around the delineation of state-owned urban land and rural collectively owned land, as well as local government resistance because of localities' continued dependence on land sales for revenue. Ongoing delays in such important land-related legislation, over the same set of legacy issues that has stifled land reform progress for years, if not decades, reinforces our assessment that land reform is not a major priority for the current administration and that our indicators are unlikely to improve meaningfully in the coming quarters.

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 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 (used in the 1990s as well) 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

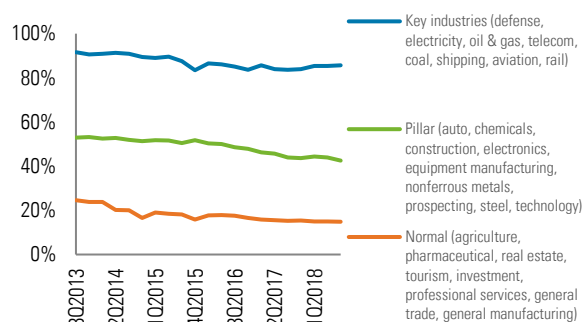
directors to replicate the structures of other commercial entities. But it also required all SOEs to institutionalize the role of Communist Party Committees into their articles of association and give the Party oversight for all strategic decisions. As a result, boards of directors still lack de facto authority to manage SOEs' operations.

METHODOLOGY

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

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Share of SOE Revenues in Different Industry Categories
4qma, percent



Source: Bloomberg, Rhodium Group.

- SOE reform is backsliding this quarter: our indicators show SOEs advancing at the expense of private firms, and policies focused on increasing Communist Party supervision instead of reform.
- SOEs did not withdraw from even the least strategic industries, while the private sector shrank within the

economy as a result of capacity cuts and slowing credit growth.

- Policy developments point to risks ahead: Party supervision alone is not leading to SOE rationalization and has a chilling effect on competition both at home and in international markets.

THIS QUARTER'S NUMBERS

Our primary indicator tracks the share of SOEs in listed company revenues. It shows little progress in state sector reform. The 2013 Third Plenum Decisions defined reform as including withdrawal of state influence from SOEs in commercial sectors, but we find little change even within normal industries where the market should play a decisive role. In 3Q2018, SOEs enjoyed 14.8% of revenue in these industries, marking only a 0.1 percentage point decline from the previous quarter. Since 2016, the SOE revenue share in commercial sectors has declined only slightly, revealing a stall in progress toward 2013 goals.

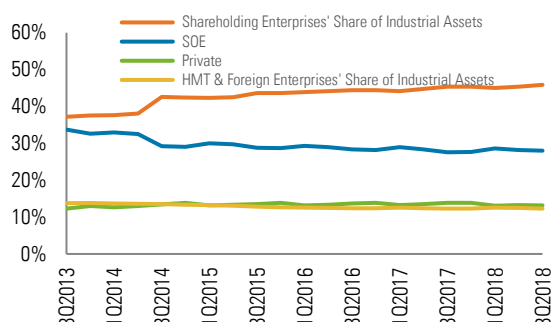
In “pillar” industries where Beijing sees strategic linkages to the country’s economic development, SOE revenue share declined by 1.4 percentage points from last quarter. In “key” industries that Beijing considers strategic and linked to national security, SOEs’ revenue share *increased* by 0.4 percentage points this quarter. We do not expect SOEs’ dominant role within these industries to change substantially in future quarters. The increase in revenue shares captured by state firms in key industries indicates that intentions to use “mixed ownership” trials to bring in private investment are not improving competitive conditions.

That SOEs are actually growing, not shrinking, adds to the current global fallout over the uneven playing field between private and foreign firms in China, a point frequently cited by the United States in the ongoing trade war. Private firms were hurt disproportionately by government-led capacity cuts and deleveraging, while SOEs were able to enjoy higher prices, maintain easier access to credit, and sometimes acquire troubled private firms. Only SOEs saw increased returns on assets (see **SOE Return on Assets**), lower leverage ratios (see **SOE Leverage**), and improved debt service capacity (see **SOE Interest Coverage Ratio**) this quarter, in line with last quarter’s results. Private firms’ leverage ratios rose because their assets declined, not because they had access to additional credit facilities. Growth in private firms’ assets slowed significantly early in 2018 and dove into negative territory by June. As a result, private firms’ share of industrial assets declined to 13.1% in

3Q2018 from 13.9% in the same period a year earlier (see **Industrial Assets by Ownership**).

Supplemental 1: Industrial Assets by Ownership

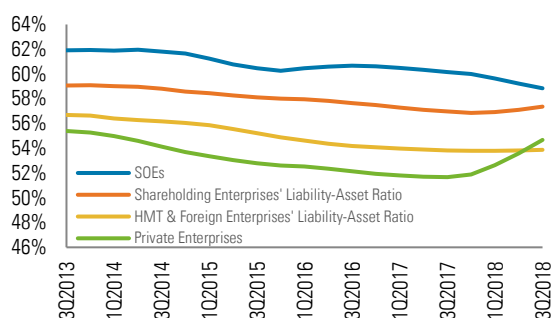
Percent



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

Supplemental 2: SOE Leverage

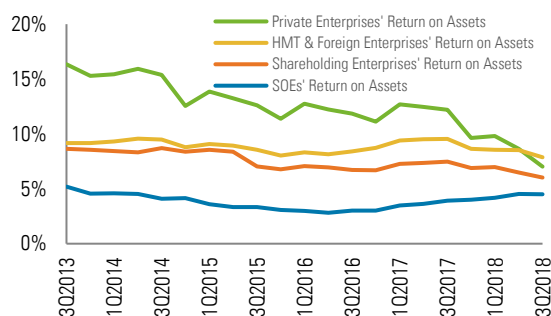
12mma, percent



Source: Ministry of Finance, Rhodium Group.

Supplemental 3: Return on Assets

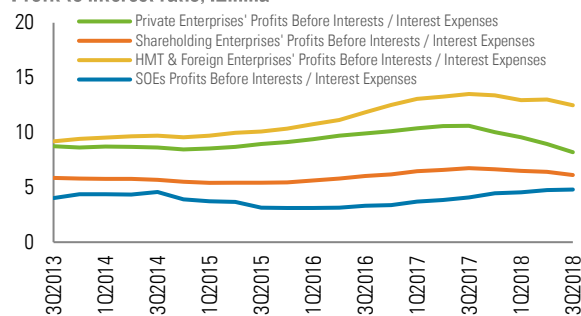
Percent



Source: State-owned Assets Supervision and Administration Commission, Rhodium Group.

Supplemental 4: SOE Interest Coverage Ratio

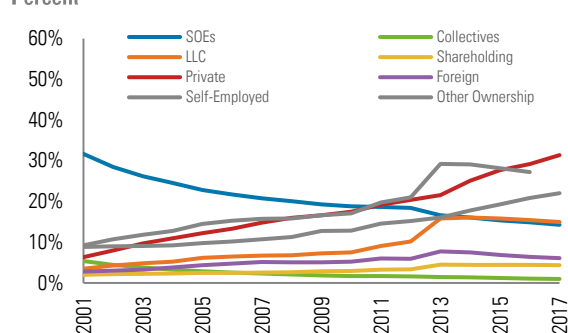
Profit to interest ratio, 12mma



Source: Bloomberg, Rhodium Group.

Supplemental 5: SOE Share of Employment

Percent



Source: National Bureau of Statistics, Rhodium Group.

POLICY ANALYSIS

Policies announced in the review period strengthened Party supervision over SOEs rather than invigorating market-oriented reforms. In September, the China Securities Regulatory Commission (CSRC) updated guidance concerning corporate governance for companies listed in China, requiring all firms to support Party-building activities and listed SOEs to codify Party leadership into their articles of association. SOE Party Committees were directed to serve a “leadership core” function and to ensure compliance with national strategies by strengthening control over personnel appointments and major decisions, taking precedence over the authority of boards of directors. (For more details, please [see our latest report](#) on SOE governance published with the Asia Society of Northern California). In short, these actions move in the opposite direction from 2013 Third Plenum reform goals to *withdraw* state influence from commercial SOEs.

The call for private firms to support Party-building activities is particularly concerning. Beijing attempted to clarify these requirements with more detailed Party documents during the review period, which stated that Party Committees of private firms are not authorized with the same “leadership” function as in state firms.

Instead, their role is to ensure private firms’ compliance with laws and regulations. However, tasking the Party to police private firms from inside is no way to transparently discipline market participants.

Beijing is particularly strengthening supervision of SOEs in the financial sector. In October, the State Council reported on state assets to the National People’s Congress. For the first time, the report covered not only nonfinancial SOEs governed by the State-owned Assets Supervision and Administration Commission (SASAC) but also financial SOEs governed by the Ministry of Finance and other state assets held at central and local government levels. The report highlighted the size of China’s financial SOEs: together they hold RMB 241 trillion (\$34 trillion) in assets and RMB 217 trillion (\$31.4 trillion) in liabilities, compared with nonfinancial SOEs’ RMB 183 trillion (\$26.5 trillion) in assets and RMB 118 trillion (\$17 trillion) in liabilities. To put these numbers in context, China’s state-owned financial assets are worth around half of global GDP at current exchange rates.

Beijing is clearly concerned about the scale of these financial SOEs and potential risks associated with their rapid expansion over the past decade, which explains why they were included within this stocktaking exercise. It remains unclear what Beijing will *do* with these giants, which are large enough to present systemic risks not only to China’s system but also to the global economy writ large.

In November, policymakers responded to growing concerns about the retreating Chinese private sector. President Xi Jinping made two widely publicized speeches during the month praising private entrepreneurs and assuring them of official support. On November 9, Guo Shuqing, the central bank’s party secretary and the head of China’s Banking and Insurance Regulatory Commission (CBIRC), [proposed](#) that 50% of all new corporate lending would go to private firms within three years (see [Financial System](#)). And on November 16, the tax bureau [announced](#) that it would defer tax collections for private companies struggling with financial distress.

While these commitments reflect rising concerns among policymakers about falling private sector growth, they are a far cry from serious reform. Setting lending targets for financial SOEs on this scale is not only inefficient but also dangerous – Guo’s 50% commitment immediately encountered backlash in the domestic financial sector over fears of additional bad debts on banks’ balance sheets. The backlash made clear that it is increasingly difficult for Beijing to demand

both rapid growth and political control given the size of China's economy today and the extent of its integration with the global market.

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. But 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, nondiscriminatory (“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 (FTZ) in 2015, to facilitate cross-border e-commerce trade. Key developments include gradually lifting equity caps for foreign e-commerce businesses in FTZs 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 the Maldives in December 2017. Beijing is currently negotiating seven other FTAs.

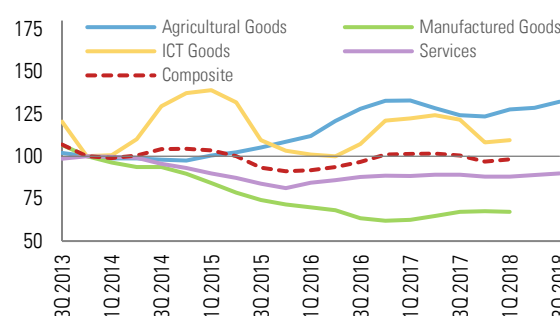
METHODOLOGY

To gauge trade liberalization progress, we assess the change in China's imports of a selection of highly protected goods and services using a composite trade liberalization index (CTLI). Scores higher than 100 indicate a growing role for these imports relative to GDP since 2013; 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.

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Composite Trade Liberalization Index

4qma, 4Q2013=100



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

- We slightly improve our assessment of trade reform but remain negative given the piecemeal nature of policy change and continued failure to report key data.
- Indicators show improvement in overall external balances but no progress in structural reform.
- Policy developments this period included pledges to increase imports and lower barriers, as well as a round of tariff cuts for some goods.

THIS QUARTER'S NUMBERS

For the second quarter in a row, our quantitative analysis of China’s trade policy is hindered by missing goods trade data, which officials attribute to technical problems with a vendor company. As a result, our primary indicator, the **Composite Trade Liberalization Index (CTLI)**, cannot be fully updated. Two subcomponents of the CTLI – agricultural goods

trade and services trade – show a positive trend, with stronger improvement in imports of highly protected agricultural goods. Services imports increased only slightly and are still below 2013 levels, indicating backsliding since the Third Plenum reform program was announced. *If data remain unavailable, we may change our primary indicator of trade liberalization in the next edition.*

China's external trade rebalanced in the right direction this quarter but did not reflect opening of China's markets. China's \$23.4 billion current account surplus in 3Q2018 was the lowest for a third quarter since 2004, driven by both goods and services trade. The goods trade surplus was 3% of GDP, the same level as in 2Q2018, while the services trade deficit expanded to 2.4% of GDP from 2.1% (see **External Trade**). Higher oil prices in 3Q2018 were the main reason China paid more for goods imports and the goods surplus did not rise further. China's exports remained resilient throughout 2018 despite the introduction of U.S. tariffs, and some exports were probably front-loaded ahead of tariff implementation, suggesting weaker Chinese shipments in 2019.

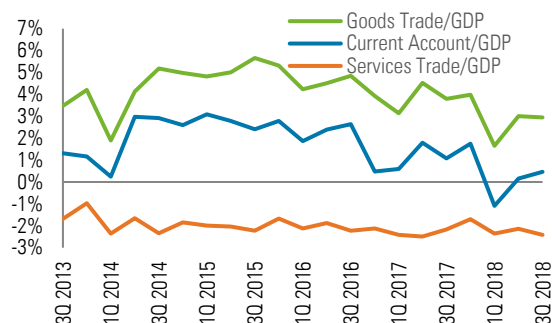
China's services trade deficit reached a new record of \$82.2 billion, driven once again by tourism, not opening of domestic services markets. Outside of tourism, only transport services (freight and passenger transport) and to a lesser degree royalties (payments for the use of intellectual property) increased (see **Services Trade Openness**). For financial services, third-quarter imports were less than \$0.5 billion, lower than imports of nearly every other commercial service.

Structural rebalancing toward higher value-added and consumption-driven trade did not progress this quarter. China imported less for domestic consumption and more for processing, or reexport, compared with last quarter (see **Structural Change in Goods Trade**). China's exports contributed more to global overcapacity in certain products. Net exports of aluminum products, coke, and fertilizer rose relative to 2012 levels, while net exports of steel products and lead-acid batteries remained basically stable (see **Trade and Overcapacity**). *Due to missing trade data, we had to slightly adjust our methodology for gauging overcapacity exports. We now focus on fertilizer trade, rather than a broader category of chemical products used in past updates. In addition, we look at rolling sums of net exports rather than quarterly average net exports, resulting in smoother lines, and changed the base year for comparing net exports from 2011 to 2012 due to data availability. The broad trends are consistent across methodologies.*

Notably, the renminbi (RMB) depreciated sharply against the dollar in July and August, falling 6.6% against the U.S. dollar on average from 2Q2018 to 3Q2018 (see **Exchange Rate Fluctuation**). This reflected greater central bank tolerance for RMB volatility in those months. Depreciation slowed in September, possibly because regulators intervened to avoid derailing trade negotiations with the United States. Monetary policy conditions support a weaker RMB, and the central bank remains concerned about the impact of capital outflows on domestic financial conditions, augmenting the instinct to stabilize the RMB. There is little evidence that China was driving the currency weaker in order to support exports.

Supplemental 1: External Trade

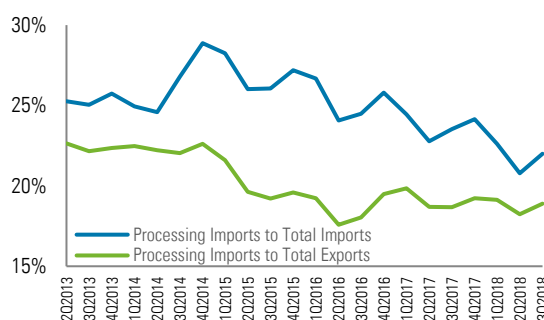
Percent



Source: State Administration for Foreign Exchange.

Supplemental 2: Structural Change in Goods Trade

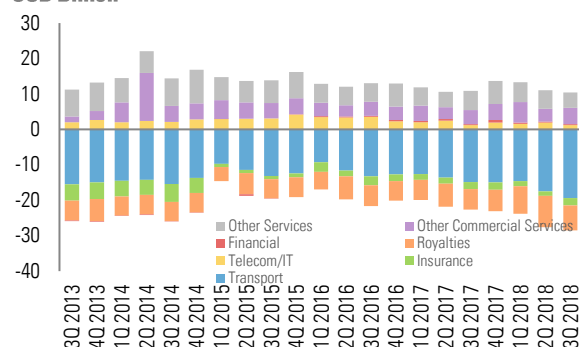
Percent



Source: General Administration of Customs.

Supplemental 3: Services Trade Openness

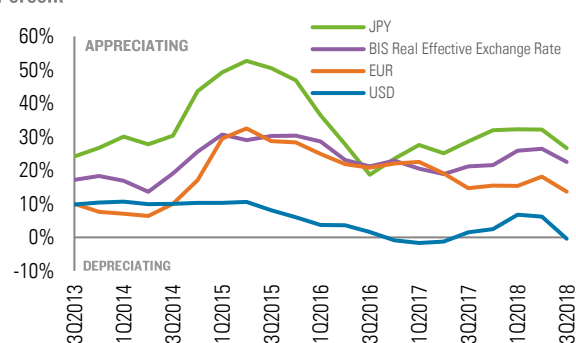
USD Billion



Source: State Administration of Foreign Exchange.

Supplemental 4: Exchange Rate Fluctuation

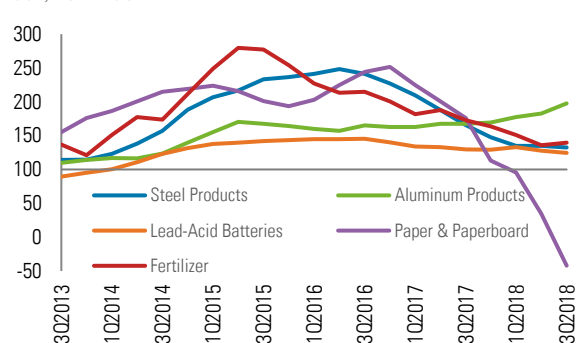
Percent



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

Escalating talk of a trade war between the United States and China complicated Beijing's policy agenda throughout 2018. In 3Q2018 and 4Q2018, officials redoubled measures that appear reform oriented but are mostly targeted at offsetting the impact of U.S. tariffs.

For the most part, the policy direction in the second half of the year encouraged accelerated import growth in

line with the needs of the domestic economy. In November, at China's first International Import Expo – an event meant to demonstrate that China's market is open to foreign products – President Xi promised that China would lower tariffs, expand market access, and increase imports. However, the expo generated more skepticism than confidence from audiences questioning the implementation of promised reforms.

Cutting import tariffs is an area where Beijing has made progress, with successive rounds of tariff cuts on highly protected goods picking up since 2015, but change has been gradual and piecemeal. On November 1, the State Council reduced tariffs on 1,585 line items to facilitate industrial upgrading, lower corporate costs, and meet domestic demand. Average tariff rates for electromechanical equipment fell from 12.2% to 8.8%, for textiles and building materials from 11.5% to 8.4%, and for resources and primary products from 6.6% to 5.4%. The State Council said the measures would reduce China's average effective tariff rate on goods imports to 7.5% in 2018 from 9.8% in 2017.

While trade policy reform has not been prioritized within Beijing's overall reform agenda since 2013, it has become more urgent as domestic and international pressures build; in this quarter, however, progress was not commensurate with the heightened urgency.

After Presidents Trump and Xi met at the G20 summit in Argentina on December 1, the United States and China agreed to suspend further tariff increases while engaging in trade negotiations with a new March 1 deadline for progress. Mid-level officials met in Beijing in January to pin down the framework and negotiating items, and Vice Premier Liu He visited Washington in late January for higher-level talks. U.S. negotiators are looking for increased Chinese purchases of key exports, improved market access, as well as structural reforms around state subsidies, industrial policies, forced technology transfer, and strengthened intellectual property protection and enforcement. Beijing seems serious about addressing certain U.S. requests, but a "grand bargain" will be difficult.

Since the summit, Beijing offered a few signs of reform intent. They include establishment of a national intellectual property rights court, reduction of retaliatory import tariffs on U.S. autos and parts to the rate charged on other countries' imports, allowing some purchases of U.S. soybeans and approvals of genetically modified crops, potentially revising the Made in China 2025 high-tech industrial policy to incorporate foreign firm participation, and revising guidelines governing foreign investment in China (see [Investment](#)).

Looking ahead to the end of the 90-day period, one key question for the outlook on China's trade policy is whether the trade war threat will compel Beijing to accelerate reform and opening up – and whether any measures addressing U.S. concerns are clearly verifiable. While a limited deal based on more Chinese purchases of U.S. goods and some additional market access is possible, a sustainable resolution still depends on fundamental reforms in China.