Asia Society POLICY INSTITUTE

RHODIUM GROUP

China Dashboard
Spring 2019 Update

May 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.

SPRING 2019 CHINA DASHBOARD NET ASSESSMENT

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.

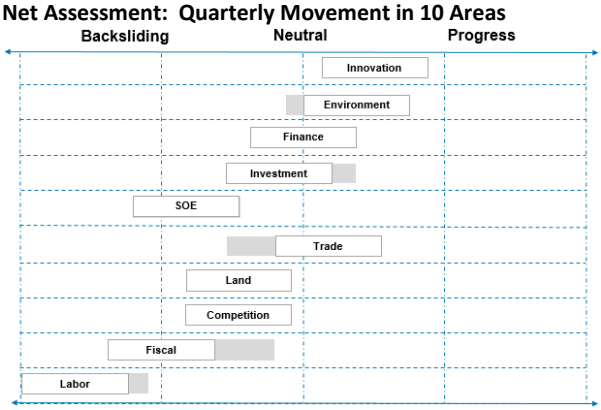
BOTTOM LINE

After a year jockeying for leverage in their trade negotiations, the United States and China stumbled into major tariff escalation in May 2019. Debate devolved into recriminations: *was* there really a deal to break, and if so who broke it? To answer these questions, we must analyze China's movement toward or away from the implementation of its economic reform commitments in response to the economic stress of the past year.

China is facing tremendous economic challenges. Economists have warned for a decade that reliance on ever-growing debt levels to fuel expansion would have to end, and when it did, GDP growth would fall. Having grown the banking system to 45% the size of *global* GDP, from little more than 5% a decade ago, the marginal return on further investment in China has been greatly diminished. The question is whether Beijing intends to fix this low-productivity situation by stepping-up market reforms or by reverting to state planning.

China's leaders insist that nothing about its "reform and opening" policy has changed in recent years. But the China Dashboard indicators we evaluated to track policy directions suggest that many reform objectives have gotten bogged down or even reversed in recent years. Today's reform challenges are increasingly difficult and structural. As China's economy grows more powerful and competitive globally, it must increasingly converge with the levels of economic openness of other advanced economies. That has simply not been happening.

Net Assessment: Quarterly Movement in 10 Areas



THE DASHBOARD GAUGES: PRIMARY INDICATORS

China's economic growth fell steeply in 2018 as a result of a necessary reduction in the growth of imprudent financing. We are now six months into a recovery, with first quarter 2019 GDP growth reported at 6.4%. Which strategy got us here? On net, we are seeing short-term stimulus at work, not reform. Three of the four Dashboard indicators that shifted in this period moved away from reform, not toward it.

Of these, the most concerning is our fiscal assessment — one of the best barometers of whether stimulus policies are being deployed at the expense of structural reform. We downgrade our assessment of **Fiscal Affairs** in this Dashboard edition because, once again, local government expenditures are rising faster than revenues. This indicates that Beijing is prioritizing short-term results over durable fiscal policy. Spending on infrastructure drove local fiscal deficits. Falling land-sales revenues sound an alarm for the property market outlook, but they are just as concerning for local government capacity to ongoing debt service obligations. Beijing will likely have to turn to even more stimulus and local fiscal support (including bailouts) in the months ahead to maintain stability.

Other clusters with negative movement were **Cross-border Investment** and labor market reform. While we saw a new foreign investment law and some capital market and

financial services openings in this period, gross cross-border capital flows as a percent of GDP declined to the lowest level in six years. Foreign investors remain hesitant about China due to concerns about restrictions on outflows, exchange rate fluctuations, and the overall growth outlook.

Labor reform, meanwhile, has long been one of our most negative assessments and now is even more so. Our primary indicator shows migrant worker income growth is currently 30 percent below the headline GDP growth. China's workers are seeing their share of national income shrink *despite* labor shortages across the country, a sign of continued inefficiencies in labor markets.

The only reform area where we upgrade our assessment this round is, ironically, **Trade**. In areas of our highly protected product import tracker where data is available (agricultural goods and services), we saw moderate improvement in import intensity, and we observed considerable tariff cuts in other product areas. It is fair to observe that this reform movement coincides with the tremendous pressure for liberalization coming from abroad, especially from the U.S.-China trade war, but also from Europe and other advanced economies.

At the second Belt and Road Forum in late April, President Xi Jinping even acknowledged that China had "anti-competitive, market-distorting, unreasonable subsidies, regulations, and practices," which he promised to remove. This was an unusual public recognition by China's president that validated the urgency and sense of grievance that China's trading partners have expressed and that the Dashboard points to.

While structural reform has not taken off, there has been an uptick in *talk* about helping the private sector, reducing the overreach of Beijing on industrial policy (i.e. Made in China 2025), and addressing other elements needing reform. Yet, most of the improvement in private sector conditions over the past nine months has been from lower interest rates and increased access to short-term working capital loans, which represents loose financial policy, not structural reform. This is akin to a blood transfusion that provides short term sustenance but does not address the fundamental pathology at play.

The National People's Congress (NPC) is the signature annual opportunity for China to show its institutional directions, and the 2019 session occurred during the drafting of this edition of the Dashboard. On the whole, the NPC was a missed opportunity to demonstrate reform progress. China's leaders point to several elements of this year's Congress as proof of their reform commitment, including passage of a new unified Foreign Investment Law meant to address long-standing global concerns regarding technology transfer and intellectual property theft. As highlighted in our **Cross-border Investment** and **Innovation** clusters, the global response was tepid given vague language and uncertainties about implementation. Premier Li Keqiang also promised to better "balance the relationship between government and market" and committed to accelerating the restructuring of oil, electricity, and railway state-owned enterprises (SOEs).

These would be positive moves. But at China's current stage of development and competitiveness, piecemeal steps are not sufficient. The question is not just what is being done, but also what major imperatives are going unaddressed. Here are three. First, while the leadership promises structural reform and privatization of at least some SOEs, it has yet to even classify publicly which industries are to be state-directed and which left to the market. Without this clarity, private investors cannot be confident of fair treatment when participating in "mixed ownership" reform trials. Second, U.S. and Chinese officials are negotiating the relaxation of some joint venture requirements for foreign investment in some sectors, but an explanation for why an economy of China's size and dynamism still has mandatory joint venture requirements *in the first place* is missing. And third, while leaders talk about bankruptcy reform and the need for fiscal prudence, they are not talking about the proliferation of trillions of renminbi in "government guidance funds" and other sources of soft budget support that keep zombie firms afloat.

So we can see recovering growth in 2019, but due to fiscal, monetary, and regulatory stimulus, not reform. This approach cannot last. The difficult policy choices required to put China on a sustainable track, which are the same things needed to land a meaningful "deal" with Washington and other partner governments, have not yet been made and are not assured.

THE VIEW FROM ABROAD

In the May meltdown in U.S.-China trade negotiations, Washington asserted it had gotten the concessions it needed only to have China "break the deal." China, meanwhile, insists that Washington changed its position on the scale and content of its proposed additional purchases of American goods.

Any deal would entail meeting *somewhere* between the two ends of the spectrum and compromising. The trick is to figure out where the middle is. Neither side has yet made available what was agreed upon and what was not.

If the Chinese starting point for compromise is the ambition for reform, opening, and marketization that Xi Jinping set out at the November 2013 Third Plenum, then meeting in the middle might well be possible. Mostly, it would mean agreement on temporary, interim measures needed to

bridge the gap until China implemented its self-declared policy reform objectives.

If, on the other hand, Washington is asked to split the difference based on where Chinese policy is trending today – as seen through the China Dashboard lens – then a deal is less likely, given how far Beijing has diverged from even its own reform intentions of six years ago.

President Trump's bellicose public handling of the last round of negotiations in Washington has not helped the process of finding a way through. Beijing, in response, published its own red lines on which it will not compromise. This has been reinforced by a patriotic call to action in China and public admonitions not to be intimidated by the United States. These and other chest-thumping gestures are compounding the political difficulty of reaching agreement, as internal critics in China argue that they have already conceded too much. Now, more than ever, both sides would be much better served by talking about an objective framework for gauging reform alignment and the work that needs to be done. The China Dashboard will be waiting when the two sides are ready for a more constructive dialogue.

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. New business registrations have risen steadily in recent years as a result, and in 2018 the World Bank recognized progress by substantially increasing its scoring of China's "ease of doing business" compared with other countries. The State Council has promised to similarly reduce barriers to market exit, but progress has been much more limited.

- In June 2016, the State Council launched a "fair competition review mechanism" to clean up anticompetitive policies issued by government agencies at all levels. The mechanism did not clarify whether industrial policies should be considered anticompetitive, did not establish a transparent process to identify which current policies were anticompetitive, and did not prevent new anticompetitive policies from being implemented.

- Beijing has updated several competition-related laws since 2013 to reflect changing market conditions. In November 2017, China revised its 24-year-old Anti-unfair Competition Law (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 and private firms and between domestic and foreign firms remains a major concern.

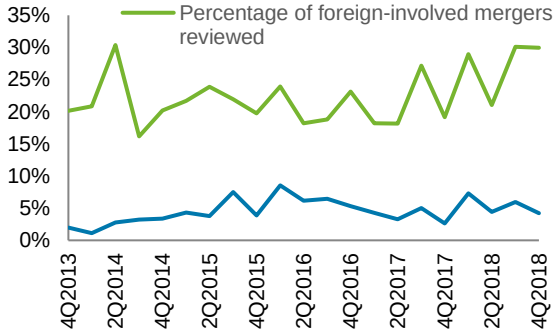
- In March 2018, China's National People's Congress approved a government restructuring plan that merged functions from various agencies responsible for enforcing competition policy. The new agency, named the State Administration for Market Regulation (SAMR), now oversees all aspects of China's competition 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, at the same level as in our last review. Our primary indicator shows that foreign firms are still treated differently in merger reviews despite regulatory reforms—our litmus test for progress.

- There are some bright spots in our supplemental data: courts are handling more competition-related disputes, and the government is making progress in lowering barriers to market exit.

- Beijing renewed commitments to competition-related reform at the National People's Congress (NPC) in March, and efforts to curtail market-distorting policies by local governments are proceeding. However, there is little sign of intent to fix the most structural and fundamental

problems related to state-owned enterprises and industrial policies.

THIS QUARTER'S NUMBERS

Our primary indicator shows that foreign and domestic companies are still treated unequally in China, despite all the recent talk of "competitive neutrality" (see **Winter 2019** edition). In 4Q2018, SAMR reviewed 88 mergers, 70% of which involved foreign companies. Compared with the number of deals announced during the period, 30% of all foreign-involved mergers were subject to additional regulatory scrutiny but fewer than 4% of purely domestic mergers received the same treatment.

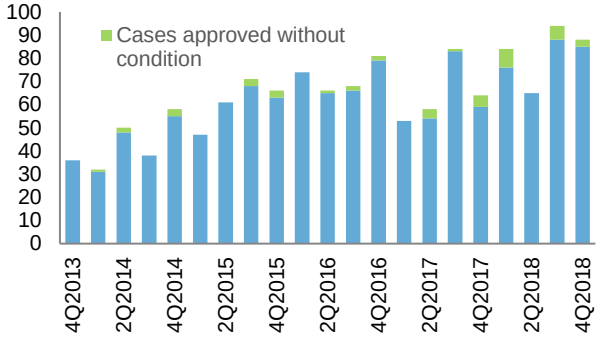
Despite this asymmetry, SAMR claimed in a press conference during the NPC on March 16 that the agency applies a "neutral" regulatory approach to all firms, citing data that 40% of its antitrust investigations in 2018 were of state-owned enterprises (SOEs), while only 10% of investigations were of foreign companies. This might be true if one includes investigations into anticompetitive behaviors such as market division and price collusion, but it is unclear whether those investigations led to fair outcomes for firms of different ownership. At least for merger reviews, our data (see **Results of Merger Reviews**) show that regulators have never halted a merger involving domestic firms, whereas 24 foreign mergers had to adjust their plans as a result of reviews since 4Q2012.

Judicial transparency also has great room for improvement, making it hard for businesses to defend their competitive positions through the legal system. The Supreme Court published 12,829 cases settled in 2018 related to competition and intellectual property disputes (see **Judicial System Transparency**). More cases may be published over time, but for now they account for only 4% of the 305,000 cases accepted by Chinese courts throughout the year; this number was a 42% increase in the number of cases reviewed in 2018 from 2017. In other words, Chinese courts are handling significantly more competition-related cases each year, but the degree of transparency around these proceedings has not improved.

One bright spot is that Beijing has lowered barriers for market exit. This is an important improvement in China's competitive environment—less efficient firms must exit the market for more efficient ones to grow market share and gain pricing power (see **Pricing Power Index**). Based on annual data of existing companies from SAMR, we estimate that 2.3 million companies exited the market in 2018, 36% more than in 2017 (see **Market Entry and Exit**). In addition, many more bankruptcy-related cases were settled in the courts, which is a fairer process for investors to agree on claims: courts nationwide handled 18,823 bankruptcy cases in 2018, compared with 10,195 cases in 2017 and 4,081 in 2016. This is progress.

Supplemental 1: Results of Merger Reviews

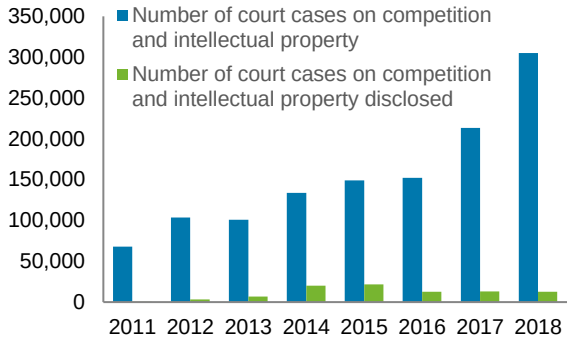
Number of cases



Source: Ministry of Commerce, Rhodium Group.

Supplemental 2: Judicial System Transparency

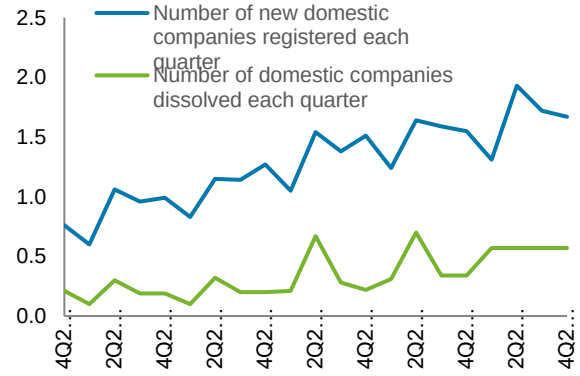
Number of court cases



Source: Judgements Online, Supreme Court.

Supplemental 3: Market Entry and Exit

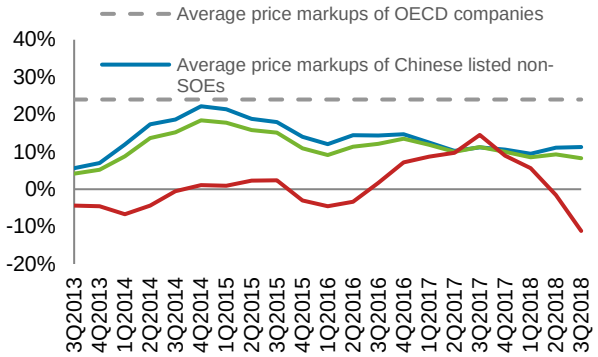
Millions



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

Supplemental 4: Pricing Power Index

Percentage



Source: Bloomberg, Rhodium Group.

POLICY ANALYSIS

Leaders talked a lot about competition policies in the review period, likely in response to a growing swell of global (including Chinese) worry about trends in China's attitude toward market competition. Leading Chinese economists grew bolder in speaking up about the importance of marketization and competition; in major capitals abroad, officials grew much more aggressive in debating responses to China. Local-level policy efforts in China have addressed some competition-related details, but they have not confronted core concerns, such as unequal antitrust enforcement and market access and—in our view, most importantly—the basic definition of which industries should be treated as normal for competition policy purposes and which require special government control. Still, leadership attention to some competition policy–related commitments is a sign that the message is getting through.

Discussion of the competitive environment was featured at the NPC in March. In his annual report on the government's work, Premier Li Keqiang identified "balancing the relationship between the government and the market" as one of three principles for this year. This is the highest profile this goal has been given since the 2013 Third Plenum, suggesting an elevation of markets and competition policy. Li also listed "promoting a fair competitive environment" as Beijing's second priority for 2019, after fiscal stimulus, stating, "markets are the most efficient way to allocate resources." This language has been largely absent in Li's work reports since 2014. In addition to "streamlining administrative procedures," one of Li's top agenda items throughout his tenure, the report also pledged for the first time to apply "fair regulation" and "competitive neutrality" to firms of different ownership types in resource allocation, market access, business operations, and government procurement.

While these central leadership pledges are encouraging, the only actual policy changes we saw this period were at the local level. In February, SAMR announced progress in China's "fair competition review mechanism"—a program initiated by the State Council in June 2016 to reduce anticompetitive policies by local governments (see **Winter 2018** edition for more details). The program is meant to constrain local governments from issuing policies that restrict market access, subsidize favored firms, or cause other distortions, especially if those are inconsistent with central government policies. According to SAMR, 98% of municipal governments and 85% of county governments have now implemented the mechanism, leading to amendments to at least 20,000 local-level policies throughout 2018. SAMR plans to extend these efforts into 2019 and introduce third-party evaluation to improve the effectiveness and fairness of the program.

China has much further to go to shape a fair competitive environment nationwide. Pledges of "competitive neutrality" will be inadequate if Beijing does not reduce SOE political advantages (see **SOE Reform**) or address the distortive impacts of industrial policies (see **Innovation**). The competitive neutrality concept has a complicated history among the advanced economies, and it means different things to different people. As discussed in our **Cross-border Investment** cluster, the new Foreign Investment Law passed in March was one potential step forward to address foreign industry concerns around issues like technology transfer and market access, though many questions remain about how the law will be implemented. Taken together, we do not see decisive actions to address fundamental shortfalls in the competition policy regime. Until such time, we will remain cautious in this area.

CROSS-BORDER INVESTMENT

THE STORY SO FAR

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

- In April 2019, several Chinese securities were included in the Bloomberg Barclays Global Aggregate Index, the first major global bond index to add Chinese government and policy bank debt. This follows the inclusion of several Chinese large-cap stocks in the MSCI Emerging Markets Index in June 2018, and more major equity and bond indices are likely to follow by adding Chinese debt and equities in the coming years.

- Meanwhile, China has backpedaled on capital account reforms. In 2014 and 2015, Beijing relaxed rules for outbound FDI, but regulators reversed course after outflows soared, pressuring the balance of payments and the exchange rate. Controls on other capital outflows were also tightened, including outbound portfolio investment and currency conversion by households.

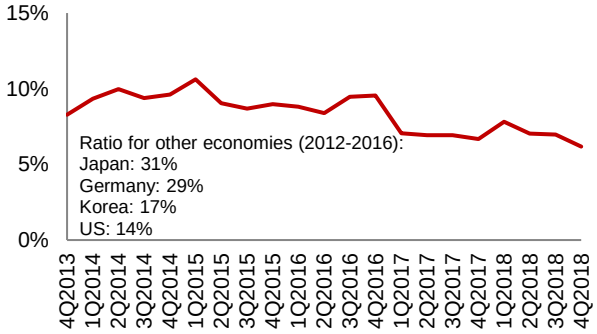
METHODOLOGY

To gauge cross-border investment progress, we sum the volume of capital flows into and out of China on a quarterly basis and divide by gross domestic product (GDP) in the same quarter. This primary indicator of China's degree of financial integration tells us how China's opening to external capital flows is progressing compared 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 moves slightly negative this quarter, from neutral last time. Gross cross-border capital flows as a percentage of GDP declined to the lowest level in six years, at 6.2%, compared to 6.9% in the previous quarter. Despite talk of reform, capital inflows and outflows shrank in late 2018—reflecting a generally sour economic mood.

- Data indicate that capital controls continue to restrict outflows, foreign investor readiness to acquire Chinese securities remains limited, and the central bank continues to intervene actively in foreign exchange markets.

- Beijing is actively courting greater foreign participation in China's financial sector—in securities brokerages, insurance, and banking—out of necessity, and continued movement toward market openness is expected in 2019.

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. By that measure, investment engagement declined late in 2018, with our ratio dropping to the lowest level of the Xi Jinping years. In value terms, 4Q2018 capital flows were the lowest in more than five years, at only $143 billion, and the second-lowest quarterly level since the end of 2010. Full-year 2018 gross flows, including FDI, portfolio investment, and other investment flows from banks, totaled $840 billion, up slightly from $816 billion in 2017 but down from $1.06 trillion in 2016.

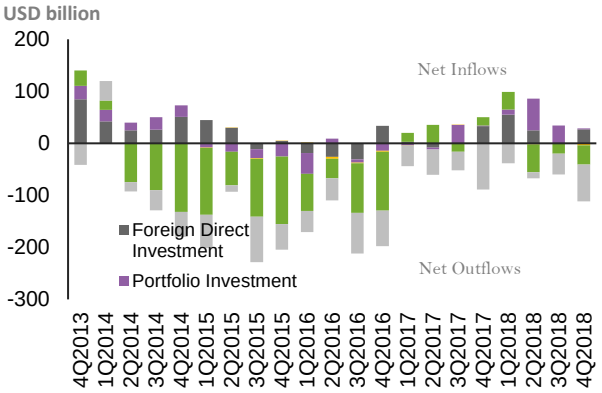
It is difficult to argue that China has become more open to cross-border investment flows in either direction since the Third Plenum reform commitments in 2013. In fact, our primary indicator has not risen much in nominal terms since 2011, and capital flows continue to shrink as a proportion of GDP. China's 6.2% ratio compares to 14% in the United States, and 31% and 29% in Japan and Germany, respectively.

Foreign appetite for China's financial market remains volatile and is driven by short-term changes in interest and exchange rates, not long-term confidence in the regulatory and investment environment. The potential for a game-changing inflow of foreign capital is there, but it has not yet shown up in the evidence. Foreign portfolio inflows, money from global investors into domestic equity and bond markets, declined to only $8.1 billion in 4Q2018 (see **Breakdown of Cross-Border Financial Flows**), after a quarterly average of $50.7 billion in the previous three quarters. While 2019 data will show some recovery, short-term concerns about currency valuations remain a dominant factor in the low inflows.

Overall foreign direct investment inflows—driven largely by corporations less sensitive to financial market conditions—rebounded in 4Q2018 to $52.7 billion from $25.2 billion in 3Q2018, but some year-end improvement is typical. Relatedly, the share of foreign buyers in Chinese mergers and acquisitions (M&A) activity did improve marginally in 4Q2018 back to levels seen earlier in the year, but the overall trend line is still lower since 2013.

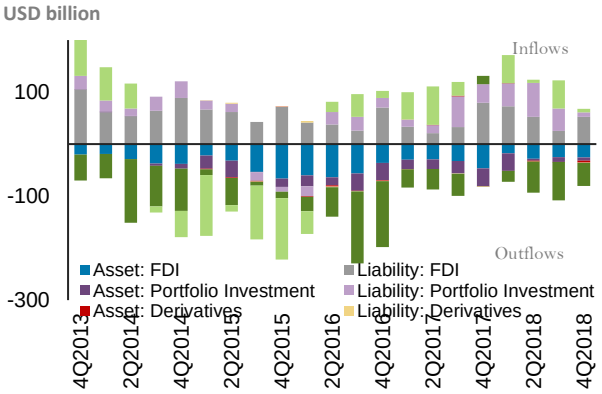
Finally, the data make it clear that currency intervention persists as a feature of macroeconomic management and that the RMB is far more controlled than other major currencies traded in global financial markets, despite government assurances that the exchange rate will be liberalized (see **Currency Intervention**). China posted a foreign exchange reserves decline in 4Q2018 of $28.2 billion, following a $3.1 billion drop in the third quarter. Reserves and inflows have rebounded in early 2019 as global central banks have become more dovish and inflows into emerging markets, including China, have consequently improved. The central bank has continued intervening in a one-sided manner, allowing some appreciation early in 2019 while resisting depreciation pressure, though the RMB slid against the dollar in mid-May as bilateral trade tensions escalated. Depreciation is an irritant with Washington, even when merited and necessary for China to fulfill long-term commitments to exchange rate flexibility.

Supplemental 1: Net Capital Flows



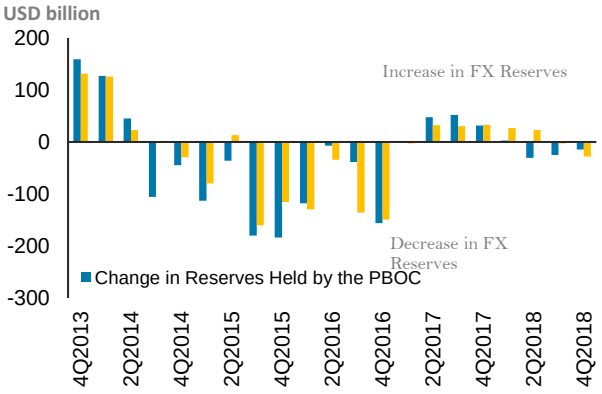
Source: State Administration of Foreign Exchange.

Supplemental 2: Breakdown of Cross-Border Financial Flows



Source: State Administration of Foreign Exchange.

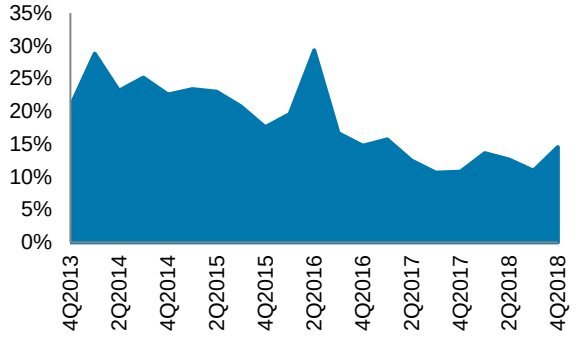
Supplemental 3: Currency Intervention



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

Supplemental 4: Foreign Appetite and Market Access

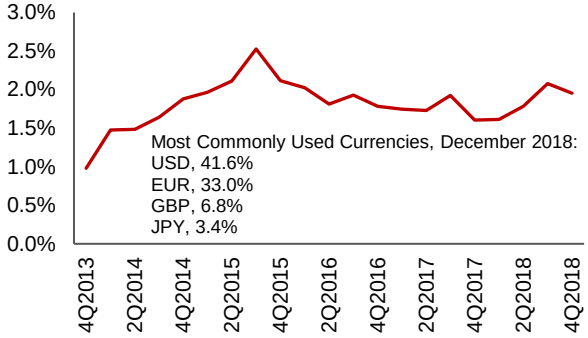
Percentage



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

The need to promote cross-border capital flows is at the heart of today's reform debate in China. With a huge appetite for foreign capital to balance the natural desire of Chinese firms and savers to diversify some of their wealth abroad, the question is whether Beijing will turn to liberalization to attract foreign investment or, rather, use administrative controls to force capital already inside China to stay there. Since late 2017, leading voices in financial policy have intimated that reforms are imminent, including relaxation of restrictions on foreign equity in brokerages and insurance firms. In the most recent quarters, this has gone into higher gear, with technocrats making adjustments to facilitate Chinese inclusion in global bond and equity indices. Investment flows are an independent indicator of confidence — or hesitation — in China's future and officials are eager for optimistic signals.

Significantly, Beijing approved a new Foreign Investment Law at the annual National People's Congress early in 2019. The law pledges to protect intellectual property rights and prohibit forced technology transfers in the context of inbound investment. It also guarantees "pre-establishment national treatment" for foreign investors and prohibits local governments from circumventing national policies. These are improvements on paper, but most foreign firms and governments remain uncertain whether this will deliver the symmetric investment conditions they require. Implementing regulations from relevant line ministries, including the Ministry of Commerce, National Development and Reform Commission, and the China Banking and Insurance Regulatory Commission, in the months ahead will be key.

Financial sector liberalization to attract foreign investment has been promising over the past six months. Given rising pressure for liberalization from abroad, opening China's financial sector to majority stakes by foreign investors is one of the easier commitments for Beijing to make: China needs to attract foreign inflows anyway. In 4Q2018, the China Securities Regulatory Commission (CSRC) approved UBS's application to hold a majority stake in its China securities joint venture, making it the first *foreign-controlled* brokerage in China. This may pave the way for a more comprehensive relaxation of foreign ownership restrictions in securities brokerages.

Other steps to increase portfolio inflows are afoot. Chinese government and policy bank bonds were added to the Bloomberg Barclays Global Aggregate Index on April 1 as part of a 20-month process that will eventually bring Chinese assets to around 6% of the global index. This follows the introduction of Chinese equities into the MSCI Emerging Markets Index in June 2018, and into the FTSE Russell Emerging Markets index effective in June 2019. These passive bond and equity indices *should* encourage foreign inflows into China's financial markets, but ultimately this depends on whether individual investors want this exposure. In addition, draft rules circulated by the CSRC in early February have proposed unifying the QFII and RQFII programs to simplify regulations and improve investor access, while allowing foreign investors to access financing for investment onshore, rather than bear exchange risk from bringing in assets from abroad as well.

In the insurance sector, reports indicate preparations to allow foreign firms to control their onshore joint ventures, and eventually own them outright. In November 2017, Beijing pledged to increase foreign ownership limits to 51% and abolish those limits within three years. In November 2018, the French insurer AXA bought out its domestic joint venture partner to take complete control, and Allianz was approved to set up a wholly owned insurance holding company in 2019. But promised details scheduled for early 2019 have not yet materialized, and formal and informal barriers beyond equity cap limits remain that are not directly addressed in new guidelines.

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, a revised Environmental Pollution Law reinforced the war on pollution by increasing penalties for polluters and integrating environmental performance into local officials' performance and promotion metrics.

- The winter of 2017–2018 featured an aggressive campaign against air pollution, including a strict coal-heating ban in northern cities. However, natural gas supply shortages and preemptive coal furnace removals prompted a heating crisis in some regions and forced officials to allow some flexibility at the local level. January 2018 revisions to the tax code also implemented sliding pollution tax rates; increased penalties; and new rewards for firms that cut air, water, noise, and solid waste pollution. Importantly, the law put local governments at the forefront of enforcement, enticing them with 100% of pollution tax revenue.

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

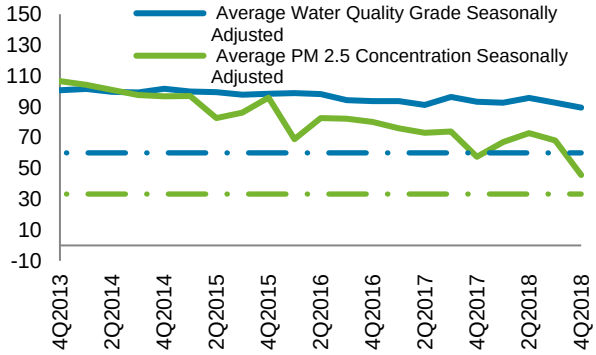
METHODOLOGY

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. Variations 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: Water and Air Quality

Percent share



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

- Our assessment of current environmental outcomes is a modest but likely temporary improvement, continuing last quarter's trend.

- Both air and water quality indices improved. Water numbers may reflect stronger environmental enforcement, as well as a slowdown in industrial activity, but air quality numbers are likely distorted by hard-to-explain low December readings in some cities.

- Environmental policymaking focused on updating previous legislation, but enforcement lost some intensity as regulators were more sensitive to winter heating needs in northern China and prioritized boosting the economy.

THIS QUARTER'S NUMBERS

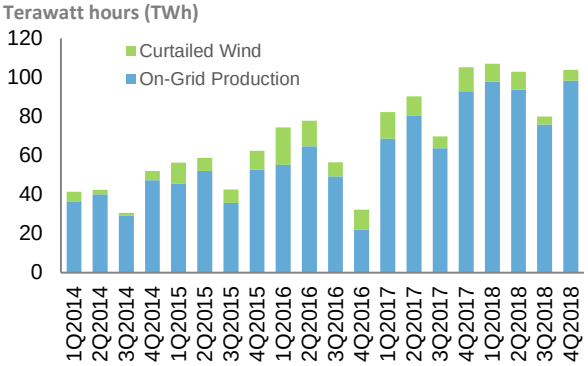
Our index indicates that air pollution appreciably declined at the end of 2018 in China's biggest cities, thanks in part to favorable weather conditions in Beijing in the latter half of December and a slowdown in industrial activity. In 4Q2018, the average airborne particulate pollution (PM 2.5) index decreased to its lowest levels since 2013 (see **Environmental Impacts**). These results should be read with some caution, however. Our indicator averages readings from only five monitoring stations and can be distorted by outlier results in a single city. In this quarter, extreme seasonally low December pollution levels in Guangzhou and Shanghai had an outsized effect on our index. Our own numbers and outside reporting suggest that air pollution increased in October and November. Though pollution levels decreased in all cities in December, the overall nationwide quarterly decrease was likely less dramatic than our index indicates.

The water quality index continued its improvement from 3Q2018 (see **Environmental Impacts**). Progress was consistent across China: of the eight river systems we track, only the Huang River deteriorated slightly. The Songhua River featured the largest water quality improvement, followed by the Yangtze River, which received special attention from policymakers in 2018 (see Policy Analysis below). This may reflect a push from last year to control waste discharge. The Soil Pollution Prevention and Control Law we discussed in last quarter and the "river chief" system, which designates responsibility for water improvement to specific local officials, may also be having positive effects, though a full analysis will have to wait until the government's June 2019water quality reports, which will mark a full year since all rivers were assigned a chief. As with air quality, water quality improvements are partly associated with slack periods in the economy, and the current surge in industrial production following ample economic stimulus is, conversely, likely to generate pollution.

Our **wind curtailment** indicator shows China utilizing its wind assets about as effectively as last quarter. Also known as "spilled wind"—wind power that is wasted because it cannot be transmitted to the electricity grid—wind curtailment was unchanged from 3Q2018. China continues to add wind capacity in an effort to reduce coal reliance; in 4Q2018, it produced the most wind energy since we began tracking in 2014. **Sales of New Energy Vehicles** as a percentage of all vehicles also increased. NEVs now make up approximately 1 in every 14 cars sold in China, and the market continues to grow despite uncertainty over government plans to end NEV producer subsidies in 2019.

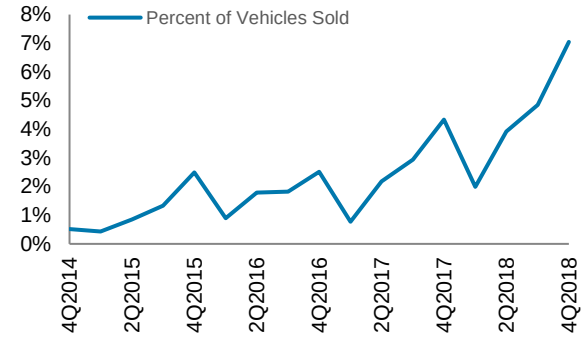
Non-fossil-fuel production nominally declined to 27% of all power, as rising demand for winter heat led to increased use of coal and other thermal power sources. On a seasonally adjusted basis, 4Q2018 renewable and nuclear energy production was actually higher compared to a year earlier, but most of this generation came in October. October 2018 non-fossil-fuel production was the highest in our index, but production quickly backslid in November and December as heating needs increased. These data indicate that China is making better use of non-fossil sources during the warmer months but is still struggling to fully utilize these sources in winter, when natural gas is the preferred coal alternative.

Supplemental 1: Wind Energy Curtailment



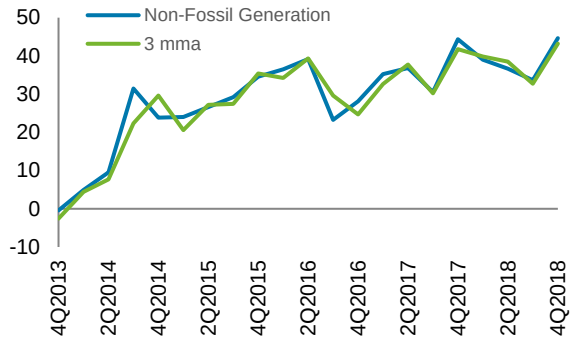
Source: National Energy Administration, Rhodium Group.

Supplemental 2: Sale of New Energy Vehicles



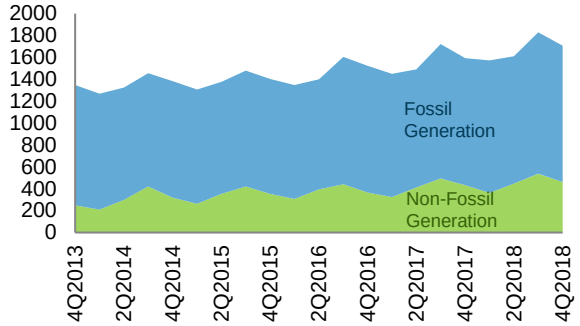
Source: China Association of Automobile Manufacturers

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

While officials claimed that environmental enforcement remained a priority, regulatory activity ebbed in 4Q2018 as leaders sought to stabilize a faltering economy. Even as the December Central Economic Work Conference declared that fighting pollution is one of "Three Critical Battles," MEE officials in 4Q2018 promised that pollution controls would not be "simple and crude" and instead would provide flexibility to regions and businesses. This shift in tone comes after rigorous enforcement in the winter of 2017–2018 resulted in widespread factory closures and heating shortages, compounded by the need to avoid further weakening economic conditions amid a broader slowdown.

As we noted last quarter, northern cities were given flexibility to set their own winter pollution reduction targets in 2018–2019. This flexibility appears to have contributed to air pollution backsliding across northern China. Although our air pollution index only captures the northern cities Beijing and Shenyang, media reports suggest that PM 2.5 levels increased in other cities in China's northern manufacturing belt. For example, a Reuters report suggested that PM 2.5 levels in Henan province rose 12% in December compared to the previous year, with local officials blaming weather conditions.

Few concrete policy measures were released throughout the quarter. Most measures consisted of implementation details for previously passed laws. Most important of the new rules were December 4 airborne pollution control standards for pesticide production. China is the world's largest manufacturer and consumer of both chemicals and pesticides, producing more than 45,000 chemicals and 3.75 million tons of pesticides annually. China is phasing out more than 30 of the most toxic compounds, but remaining pesticides are still a threat on the farm, where they leach into soil and groundwater, and in the factory. Pesticide production emits toxic air pollutants, and lax safety protocols have caused chemical leaks and catastrophic industrial accidents. In November, an explosion and fire at a Hebei chemical factory killed 23 people. The new draft rules seek to reduce hazardous emissions and limit accident risks, detailing the maximum permitted levels for certain chemicals and organic compounds and requiring sealed production facilities and air purification equipment. While tighter rules are a step in the right direction, the MEE is moving slowly on this compared to more visible smog and water pollution laws: the law to regulate pesticide emissions was initially enacted in 2016.

Some region-specific environmental plans were also announced in the review period, including clean water plans for specific river basins. The Yangtze received attention in the "Action Plan for the Protection and Rehabilitation of the Yangtze River" released on December 31. The plan set out new controls on industrial and agricultural runoff and discharge, as well as schemes to invest in water purification and ecological development.

As domestic environmental enforcement tapered off in 4Q2018, China's international environmental engagement ramped up. At the 2018 United Nations Climate Change Conference (COP 24) in early December, Chinese negotiators signaled that they would accept uniform greenhouse gas standards—provided that developing countries could set their own timetables and were given financial support. China had previously argued that developing countries should be able to set their own standards. The shift was seen as a potentially important concession on what has up till now been a major sticking point in negotiations. China's position reflects domestic environmental pressure, as well as a desire to displace the United States as a leading voice in global climate efforts.

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, RMB movements have become much more volatile. While markets have a freer hand to adjust the RMB's value, the central bank's intervention is also persistent, reducing benefits of market determination.

- In late 2016, Beijing launched an aggressive deleveraging campaign to reduce systemic financial risks that were accumulating from the growth of shadow banking activities. Despite a slowdown in economic growth, the campaign has continued, substantially reducing credit growth in China and tightening regulations around the financial system.

- Foreign investors' participation in China's financial markets has increased, and Beijing is encouraging foreign portfolio inflows in particular, with the expansion of programs such as the Bond Connect and Hong Kong 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.

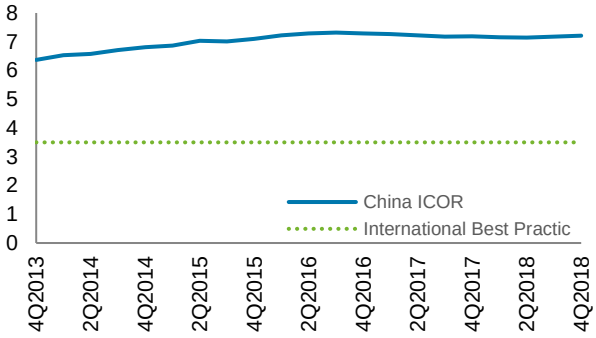
METHODOLOGY

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 shows the financial system is becoming marginally less efficient in generating growth, despite leadership pledges of reform.

- Overall credit growth continued to slow in 4Q2018 — a critical precondition for a more stable and sustainable financial system — while direct corporate financing from the bond market (rather than banks) increased.

- Moves toward liberalization in the financial sector are occurring rapidly to maintain and grow foreign investment flows into fixed income and equity markets, as well as lifting restrictions on foreign participation in the brokerage and insurance sectors.

THIS QUARTER'S NUMBERS

Analysts look to China's financial system for evidence that a return to reform is taking hold because Chinese officials have

been focusing more on financial reforms than on any other area of policy change. That focus included the deleveraging campaign over the past two years and talk of wider opening to private and foreign investment and market competition. However, we judge the outcome in financial system reform not by pledges but by their implementation, and whether this improves financial efficiency. Despite all the pledges for financial system reform, through the fourth quarter of 2018, financial markets were still becoming *less* efficient. Our primary indicator — an incremental capital output ratio — slid to 7.21 from 7.17 in the fourth quarter: more than twice as much capital required to get the same output growth as in best-practice nations. Beijing clamped down on shadowy finance more earnestly than ever last year but still did not achieve reform goals of making financial markets more open and efficient. This is the legacy of large existing debt levels, but also because politics continue to trump market forces in allocating credit. Returns continue to be low.

Overall **Growth in Credit** continued to slow, consistent with the campaign to reduce systemic financial risk. The PBOC's formal measure of credit growth, total social financing (TSF), fell to 9.8% year-on-year (yoy) in 4Q2018 from 10.6% in 3Q2018, down sharply from 16.6% yoy in 4Q2016. In reality, the slowdown is even steeper, as China's shadow banking system — some components of which are not captured within TSF — contracted. This is an essential part of financial reform, as financing had grown much faster than the real economy since the global financial crisis — an untenable situation that generated major risk.

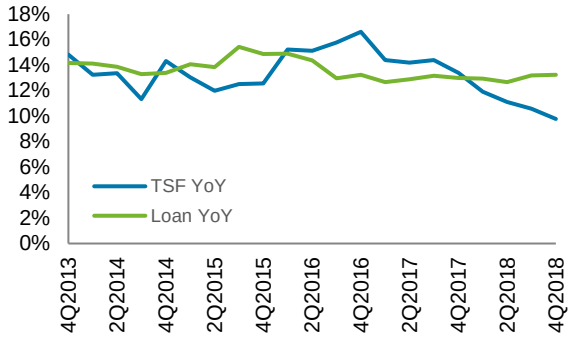
While foreign investor presence in China increased in 2018, led by rising purchases of government and policy bank bonds, its role remains extremely small. Surprisingly the rise of foreign bond ownership we noted previously flatlined in 4Q2018, dropping slightly to 2.24% from 2.27% in 3Q2018. Currency risks were the primary factor, as the central bank increased intervention in the foreign exchange market late in the year to defend the currency's value and keep the RMB below 7.0 per dollar. Expectations of currency weakness tend to reduce inflows into China's bond and equity markets. However, China's inclusion in some global bond indices in 2019 is likely to drive inflows this year, an outcome Chinese officials look forward to and regulators are attempting to promote by permitting new hedging instruments. We discuss foreign flows into China's equity and bond markets in the **Investment** cluster.

In any slowdown in credit growth in China, the private sector is squeezed relative to state firms, because state-owned enterprises (SOEs) have more fixed assets to pledge as collateral and have generally closer ties to state banks. While that pattern was evident in 2018, by year-end, data showed private-enterprise-heavy provinces sustaining more credit growth than many SOE-led provinces. Data released by the central bank showed that the more dynamic coastal provinces, such as Zhejiang and Guangdong, were seeing credit growth at more than twice the pace of the rest of the country, while some interior provinces saw hardly any new credit growth in 2018. After the difficulties the Chinese private sector endured in 2018, it will take more than a few quarters to establish confidence that Beijing is ready to pay more than lip service to leveling the playing field. But this trend does bear watching.

Money market rates declined significantly during the review period as the PBOC eased monetary policy to boost growth. This made risky shadow banking investments less attractive relative to more standard products. More financing was extended in the form of loans, and lower money market rates also incentivized corporate bond issuance, despite rising default risks in that market. This was exactly the goal of easing. 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 only 2.6% in 4Q2018, down more than 120 basis points in six months. This low-rate environment helps avoid more defaults in China, since it is easier for borrowers to cover their enormous debt service obligations. A shift in Washington away from raising U.S. interest rates in 2019 makes it easier for Beijing to keep its own rates lower, because there is less concern that capital will chase higher rates abroad.

Supplemental 1: Growth in Credit

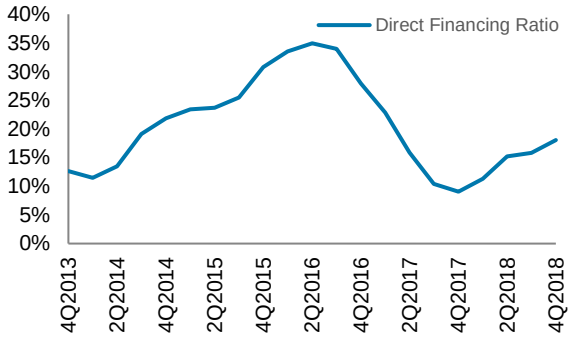
Percent



Source: People's Bank of China.

Supplemental 2: Direct Financing Ratio

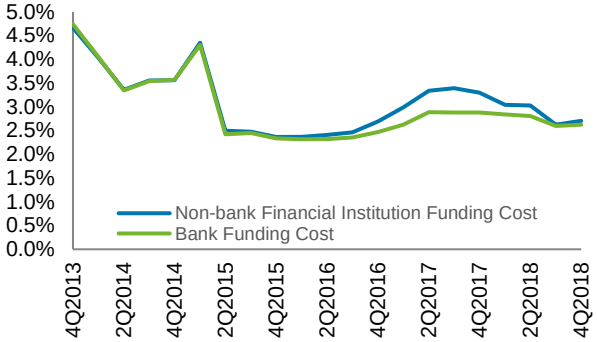
4qma, percent



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

Supplemental 3: Interbank Lending Rates

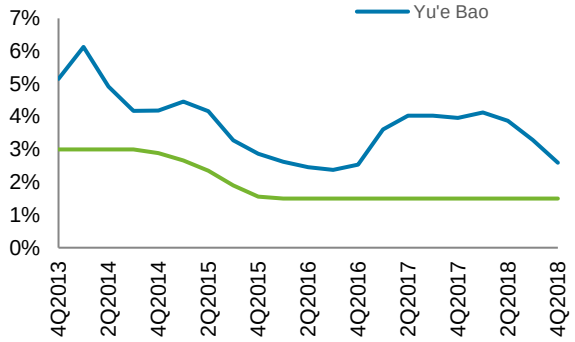
Quarterly average, percent



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

Supplemental 4: Return on Savings

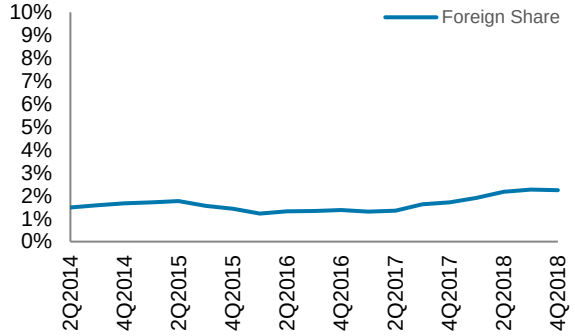
Quarterly average, percent



Source: The People's Bank of China.

Supplemental 5: Foreign Held Bonds

Quarterly average, percent



Source: ChinaBond, Shanghai Clearing House, Rhodium Group.

POLICY ANALYSIS

The big policy emphases in 2018 were deleveraging and talk of increasing financial markets' openness to foreign participation, along with improving access to finance for the private sector. The most wrenching period of China's deleveraging campaign is probably in the past, but the consequences of years of rapid credit growth still loom over the economy. Slowing credit growth was an essential step, with credit growth close to nominal GDP growth in 2018.

Maintaining a credit cleanup in 2019 will be difficult. Chinese financial institutions extended a record RMB 4.64 trillion ($690 billion) in new credit in January alone. Managing credit growth clearly remains a key tool to stabilize the economy, along with aggressive fiscal policy support. In March, the National People's Congress work report set credit and monetary growth targets in line with nominal GDP growth. That may be wishful thinking (it is likely to be much higher), but it does at least show *intent* to avoid repeating the mistakes of the last round of policy stimulus in late 2015 and 2016.

The key area to watch this year as an indicator of Beijing's stance on financial risk is the regulatory structure, which successfully limited informal financing growth in 2018. A new institutional structure implemented in May 2018, including asset management product rules, will remain in place, even if monetary easing in an attempt to stabilize growth continues.

In terms of access to China's financial markets, both Premier Li Keqiang and PBOC Governor Yi Gang made commitments to additional opening in early 2019. At the annual China Development Forum in March, Li pledged that limits on foreign brokerage and insurance companies would be lifted, and thresholds for foreign participation in credit ratings, nonbank payments, and bank card clearing services would be reduced. Yi Gang argued for more rapid development of financial hedging instruments to facilitate greater foreign inflows into China's bond market. These signals are consistent with promises dating back to at least 2017, if not sooner, but progress has been limited for now.

One of the most significant financial reforms under consideration concerns bank funding costs, to reduce the regulatory arbitrage opportunities that gave rise to shadow banking and other financial risks. By allowing money market rates (where shadow banking products are priced) and deposit rates to converge, China would move closer to a developed market system of managing rates. So far, however, even though money market rates have fallen, deposit rates have not risen. Ultimately, the goal would be lending rates determined by market forces rather than policy decisions by the State Council, but this is likely to take time.

Finally, Beijing has continued efforts to drive additional credit to the more dynamic private sector, with the banking regulator urging banks to increase lending to smaller enterprises by 30% in 2019. This is a state-directed solution in lieu of a functional financial system. Some fundamental issues limiting private sector lending include collateral shortages and the lack of sufficient net interest margins in private lending to compensate for the additional risks; interest rate cuts focused on reducing bank funding costs would assist this process.

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 what the center commands local governments to spend and the resources available to them.

- Beijing passed a new budget law in August 2014 that allowed local governments to issue bonds while banning all other forms of local government borrowing and guarantees, including the use of local government financing vehicles (LGFVs) to borrow from banks and the shadow banking sector. The law was meant to limit quickly growing local government debt levels – particularly riskier "implicit debts," or contingent liabilities – that are not recorded on official balance sheets.

- In March 2015, Beijing initiated a three-year "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 RMB 14.34 trillion ($2.1 trillion) in official debt. Only RMB 256.5 billion ($37 billion) of this remained to be swapped as of October 2018. The program, which has been extended in 2019, 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 local government tax revenue on net, given that it offered more tax deductions and was in many ways 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 RMB 30 and 45 trillion ($4.3–6.5 trillion). The heavy debt burden has been crippling for localities, and Beijing relaxed guidance on debt repayment in October 2018, allowing local governments to extend or renegotiate implicit debts.

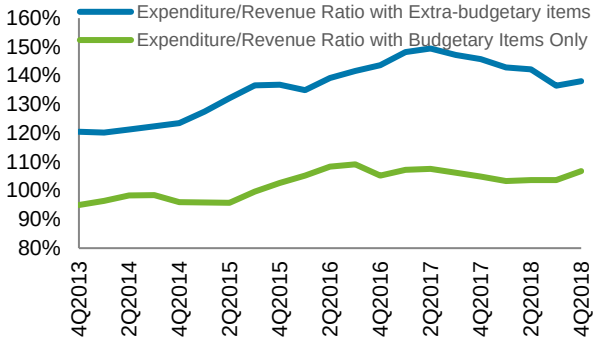
METHODOLOGY

To gauge fiscal reform progress, we watch the gap between local government expenditures and the financial resources available to pay for them, including central government transfers. Our primary indicator shows the official trend in blue and an augmented calculation of the gap including off–balance-sheet, or "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 downgrade our assessment of fiscal affairs: local government expenditures are rising faster than revenues again as Beijing leans on infrastructure spending as a stimulus tool. This is a clear sign that Beijing is prioritizing stimulating a slowing economy over durable reform to its fiscal regime.

- Our primary indicator – the local fiscal gap – worsened as special revenue bond issuance and land sales slowed while mandates to spend on infrastructure piled up.

- Promised tax cuts and other easing will aggravate local debt this year; some proposed reforms are promising but are moving too slowly to be called real improvement.

THIS QUARTER'S NUMBERS

Our primary fiscal indicator, the augmented **Local Expenditure-to-Revenue Ratio**, worsened for the first time since 2Q2017, with the ratio edging up from 136.6% in 3Q2018 to 138.1% in 4Q2018. This means a larger gap

between what local governments take in and what they have to spend – the exact opposite of what fiscal reform should accomplish. Local governments spent 38.1% more than they collected in the fourth quarter, even after accounting for off-budget financing activities. This could get worse before it gets better, at least through the second half of 2019, as Beijing attempts to boost a slowing economy through traditional channels.

A plunge in local government special revenue bond issuance was the main cause, with only RMB 159 billion ($24 billion) issued in 4Q2018, compared with a massive RMB 1.68 trillion ($250 billion) in the previous quarter (see **Sources of Local Government Financing**). This is not surprising as special revenue bond issuance is usually concentrated in the middle quarters of the year, while slowing at the end of the year as annual quotas set by the central government are exhausted.

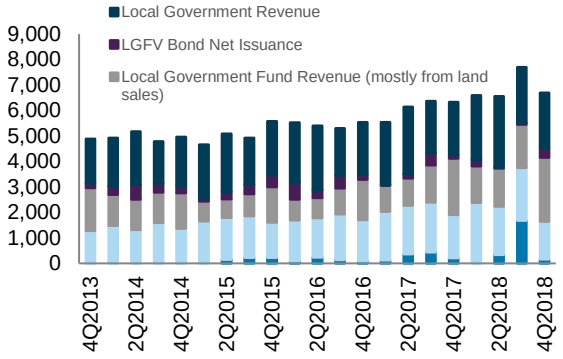
A more surprising development with worrying fiscal implications is slowing revenue growth from land sales. Growth slowed to a two-year low of 13.8% year-on-year (yoy), down from an average pace of 31.8% in the previous three quarters. This causes many analysts to think that property troubles will loom large this year, given declining sales momentum and weakening financing conditions for developers. Data from China's National Bureau of Statistics (NBS) show that growth in land transaction values in 2018 slowed to 18% from 49% in 2017 and has fallen sharply so far in 2019. Since Chinese developers have a full year to pay for land purchased at auctions, land sales revenue for localities will probably slow this year, consistent with the declining trend in purchases.

The national-level augmented fiscal deficit (see **National Fiscal Deficit Measures**) ticked up slightly in 4Q2018, from 13.8% to 14.0% of GDP, while the official fiscal deficit also rose to 4.2% of GDP from 3.5% in the previous quarter. Rising infrastructure spending to support the economy was the cause. At the National People's Congress (NPC) in March, the central government pledged RMB 2 trillion ($300 billion) in tax and fee cuts for 2019, which will also reduce local government tax intake, unless the cuts kickstart a consumer boom.

Looking ahead, local government bond issuance took off in the first quarter of 2019, as leaders authorized local governments to start selling bonds in January to reverse the fourth-quarter fiscal drought. Resulting revenue will offset some spending increases and weaker tax revenues in the short term, and increased bond issuance is an important structural improvement; however, the volume of current issuance is insufficient to forestall local fiscal risks given high existing implicit debt levels.

Supplemental 1: Sources of Local Government Financing

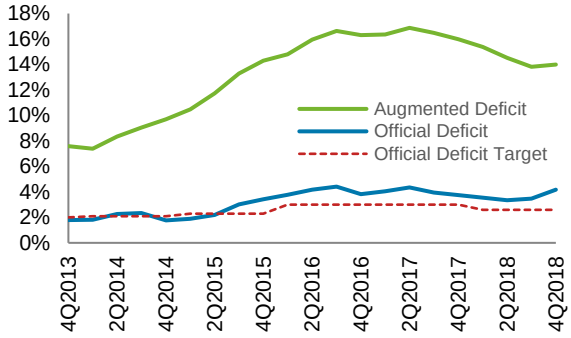
RMB billions



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

Supplemental 2: Fiscal Deficit Measures

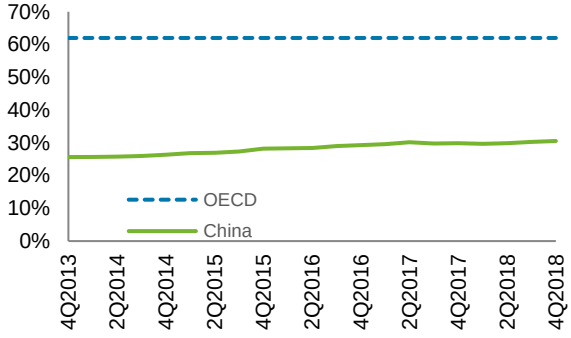
4qma, percent



Source: Ministry of Finance, Rhodium Group.

Supplemental 3: Direct Taxation Ratio

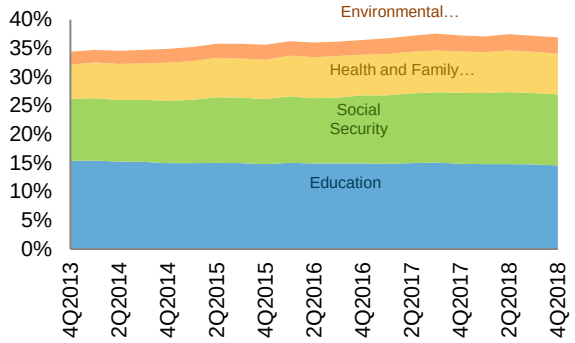
4qma, percent



Source: Ministry of Finance, Rhodium Group.

Supplemental 4: Government Social Expenditures

4qma, percent



Source: Ministry of Finance, Rhodium Group.

POLICY ANALYSIS

Fiscal reform has seen some recent experimentation, but our net assessment is still negative: while some important structural reforms have been proposed, on balance Beijing's turn toward stimulus will aggravate local debt risks this year. Fiscal reforms are not moving fast enough to turn this around. For example, while Beijing is encouraging local governments to bring in more revenues via bond issuance, new political promises of tax cuts to stimulate activity add equivalent if not larger revenue burdens. The clear focus of policy is *managing*, not *reducing,* the local debt burden.

Premier Li Keqiang announced RMB 2 trillion ($300 billion) in tax and fee cuts at the NPC on March 5 and reduced the top VAT bracket to 13% (from 16%) and the middle bracket to 9% (from 10%). In theory, leaving profit with firms to reinvest efficiently is better than taxing them or driving government investment in low-return infrastructure projects. But for the short term, growth still depends on these types of government spending. Financing that traditional investment-led growth with more debt rather than taxes will only extend financial and fiscal risks.

On the surface, policymakers understand these trade-offs and promise to reduce fiscal risks by opening wider "front-door" channels for local governments to raise new funds like bond issuance, while keeping closed "back-door" channels like riskier shadow banking and off–balance-sheet financing vehicles. Local government bond issuance (a front door) is clearly opening: at the March NPC, leaders approved RMB 2.15 trillion ($320 billion) in local government special revenue bonds for 2019 and also extended a bond swap program that allows local governments to exchange explicit debt into lower interest rate bonds.

These policies would mark marginal improvement by forcing local governments to improve the structure of their debts and take on financing more transparently. But they will not address the most worrisome part of China's local fiscal debt morass, which is the level of contingent liabilities, or hidden debts, owed by local governments. Early last year, it appeared probable that Beijing would force localities to tackle this issue head on by writing down or paying off their hidden debts; instead, in late October 2018 the State Council allowed localities to renegotiate or extend the terms of these debts. This freed up additional spending room for local governments, while leaving existing debt levels untouched and reinforcing moral hazard around these types of borrowing activities.

There are some bright spots in fiscal policy rhetoric, but new policies are not being implemented quickly. The NPC featured some discussion of a pilot program to reduce local government implicit debt, first in a few provinces and cities, by having central government policy banks play a bigger role. Zheng Zhijie, president of the China Development Bank (CDB), told reporters on the sidelines of the NPC that his bank had already provided around RMB 250 billion ($37 billion) in low-interest loans to the Shanxi provincial government the past December to replace some of the province's implicit debt. Media reports said CDB also lent to Zhenjiang, a city in Jiangsu province, and Xiangtan in Hunan province, under a similar program. If this CDB loan swap for local government debt is limited to only a few localities, the impact is likely to be fairly small. However, over time it creates a potential vehicle for a bigger absorption of local government debt by the central government.

Reformers have also long argued that imposing a property tax on existing homes would be a more sustainable revenue source for local governments than continuing to rely on land sales to developers (as discussed in This Quarter's Numbers above). Li Zhanshu, head of the NPC, pledged during the March 2019 legislature meetings that the Congress would work on a property tax law this year, suggesting possible progress despite weakening real estate market conditions. However, even if the legislation moves fairly quickly, the law will most likely only be implemented starting in 2020.

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.

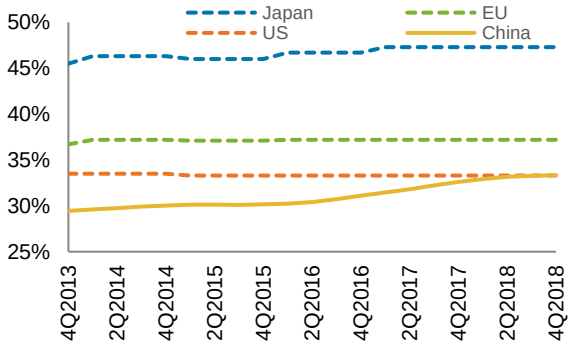
METHODOLOGY

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 moderately positive, the same as last quarter. Our primary indicator shows that China has reached parity with the United States in terms of the contribution of innovative industries to domestic economic activity.

- This may not hold, as government stimulus for infrastructure boosts lower tech industrial activity. The relative growth of the innovative industry share of output is already decelerating.

- Leaders' debate on the merits of industrial and innovation policies was on display in unusual public discussion during the National People's Congress (NPC) in March. External

pressure is growing, with the European Union (EU) now turning toward a more confrontational position.

THIS QUARTER'S NUMBERS

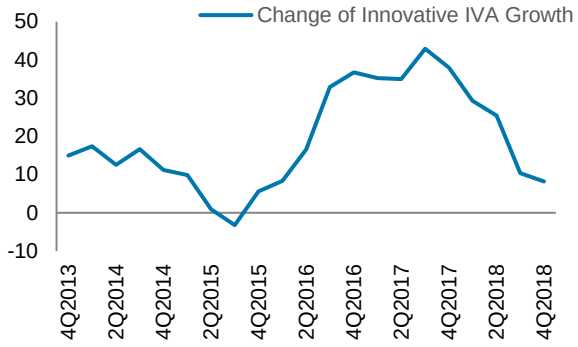
Our primary indicator, **Innovative Industry Share in Industrial Value-Added**, shows that China's innovative industries accounted for 33.3% of domestic industrial value-added in the fourth quarter of 2018—the same level as our updated assessment of the 2017 U.S. level. In other words, Chinese industrial policies have been successful based on this particular measure of innovation. Innovative industries have outpaced traditional ones in China's industrial structure for years, and now they drive as much value-added as in developed economies. We have argued for the past year that China would soon reach U.S. levels: that moment has arrived.

Whether China can sustain this is less certain. As Beijing turns back to stimulus to support the economy, traditional industries are rebounding, reducing the relative weight of innovative industries as a whole. The innovative sector is still growing, but structural adjustment is slowing (see **Volatility in Innovative Industry**).

The outlook differs among these industries. While equipment manufacturing and information technology are handling the current slowdown well, transportation equipment (both auto and non-auto) continues to slow (as in our last review; see **Industrial Value-Added Growth Rates for Specific Innovative Industries**). In value-added terms, the auto sector grew by 5.7% year-on-year (yoy) in 4Q2018, the same as the industrial average and down from 8.9% in 3Q2018. The auto sector is set for further weakness, as auto sales were down −14% yoy in the first two months of 2019. The non-auto transportation equipment sector (i.e., rail, ships, aircraft) fell below the industrial average, at 4.2%, but may rebound modestly as a result of stimulus spending on infrastructure.

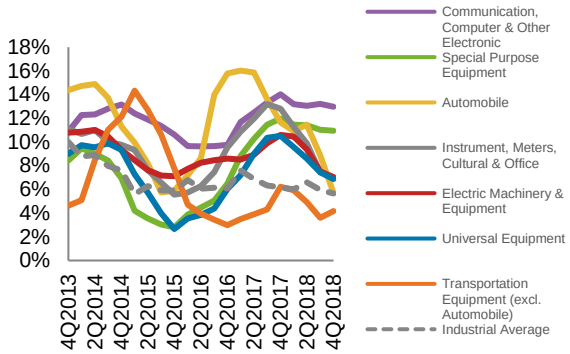
One important stimulus tool is tax relief. At the annual NPC in March, the government announced surprisingly deep corporate value-added tax cuts. Non-innovative industries will benefit more than innovative ones, likely slowing the rising share of innovative industries. Sectors like steel, which accounts for roughly 10% of total industrial value-added in our indicator, are more likely to respond to the tax cuts by expanding production instead of passing tax savings downstream. Meanwhile, some innovation-specific incentives, such as the producer subsidy for NEVs, are scheduled to phase out in 2019.

Supplemental 1: Volatility in Innovative Industry
4qma, bp



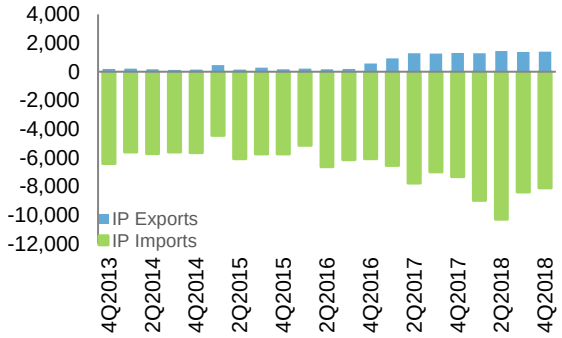
Source: National Bureau of Statistics, Rhodium Group.

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



Source: National Bureau of Statistics, Rhodium Group.

Supplemental 3: Intellectual Property Flows
USD Million



Source: National Bureau of Statistics, Rhodium Group.

POLICY ANALYSIS

Chinese officials are debating the merits of industrial and innovation policies in light of a growing global backlash and tough trade negotiations with Washington. At the NPC, former Minister of Finance Lou Jiwei issued a rare public rebuke of the flagship MC2025 industrial plan, calling it "a waste of money." Premier Li Keqiang did not mention the plan once in his annual work report to the government, and Minister Miao Wei of the Ministry of Industry and Information Technology also avoided the topic during his press interactions. This was no coincidence, and state media have barely mentioned the plan since late 2018, presumably under government guidance.

Still, while Li avoided mentioning MC2025, he did commit to building China into "a major manufacturing power," reflecting continued support in the bureaucracy for industrial policy in general. This led some observers to conclude that Beijing had merely changed its rhetoric but not any underlying policies. Another interpretation is that Beijing plans more substantive moves but is holding them back for deal making with Washington.

The NPC passed a new unified Foreign Investment Law on March 15, which nominally prohibits forced technology transfer and offers more protection from IPR infringement. Just after the NPC, the State Council announced that it had rescinded several technology import and export regulations that benefited technology users at the cost of original owners. While Beijing extolled the virtues of these shifts, the global response was cautious due to uncertainty about implementation.

One of the most important specific high-innovation sectors grew increasingly fraught this quarter: 5th-generation cellular network (5G) technology. Beijing's long-standing goal has been commercial rollout of 5G in China this year. Between 2013 and 2018, the three dominant telecom operators invested more than RMB 1 trillion ($150 billion) in the 4G network, with investments in new applications and services several times greater. But despite the attention to 5G at home and—increasingly—a battle over the reliability and security of Chinese 5G for other nations abroad, financial statements of China's major telecom operators suggest that their actual planned 5G-related investment in China will be less than RMB 20 billion ($2.9 billion) in 2019.

China's moderation on industrial policy may be too late to forestall pushback from developed economies. In March 2019, the EU Commission and the European External Action Service (EEAS) issued a statement on EU-China relations just ahead of a European Council session and President Xi Jinping's visit to Italy and France. The EU statement promoted a "more realistic, assertive, and multi-faceted approach" to China and defined China as a "competitor" in many areas, including technology leadership. Brussels and member states are talking about restricting Chinese investment, matching China's state aid with industrial support of their own, and other surprisingly robust if somewhat illiberal steps. While Europe is still viewed as less resistant to Chinese entreaties than the United States, these inchoate restrictive measures could cast a long shadow over China's ability to tap into a major advanced innovation hub.

LABOR

THE STORY SO FAR

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

- In July 2014, 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 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 that would ease and standardize the process of relocating.

- In December 2015, the central government established that anyone living in one locality for six months could apply for a residency permit and therefore gain access to basic social services. The measure softened the division between rural and urban *hukou*, and it laid the basic foundation for abolishment of the *hukou* system over the longer term.

- A notice issued in August 2016 recommended fiscal support to incentivize and facilitate urbanization and provide social services based on the newly established residency permit system. The extent and effectiveness of this support are still unclear.

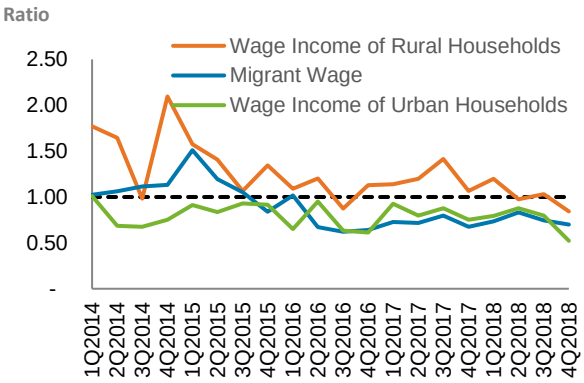
- In February 2018, China's State Council indicated that it would share more social expenditures with localities. Local governments have long shouldered a disproportionate share of overall government spending while suffering from weak sources of revenue; more revenue from the center would help bridge this gap.

METHODOLOGY

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

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Wage Growth Relative to GDP



Source: National Bureau of Statistics, Rhodium Group.

- Since migrant and urban wage growth weakened substantially compared to GDP this quarter, we further downgrade our assessment of labor and shared welfare reform progress. This occurred despite labor shortages across the country and a decline in government social spending, both of which are reasons to expect wages to rise.

- Much of the weakness in our indicator is likely due to a weaker economy, but the government is not responding by pushing through needed reform to labor markets.

- Leaders announced an "employment-first" policy for 2019 including measures to reduce employee-related expenses for companies. This might drive up wages later this year, but broad structural reform to labor markets is more important than a short-term stimulus campaign.

THIS QUARTER'S NUMBERS

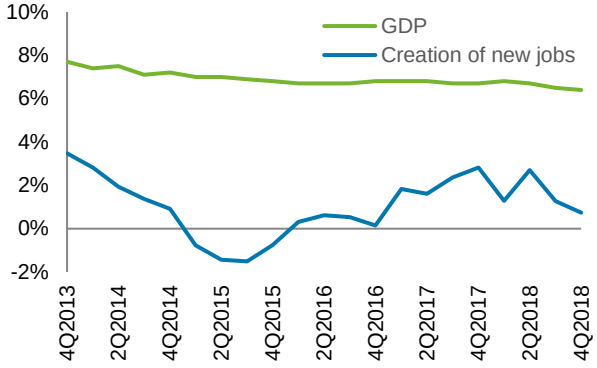
Our indicators show wage growth lagging economic growth in all categories in 4Q2018: the 2013 Third Plenum goal of lifting the "labor share of income" cannot be attained under these conditions. Real growth in migrant workers' wages, our primary indicator of Beijing's success in encouraging labor mobility and creating new employment opportunities, declined: growth was 30% lower than the rate of GDP growth in 4Q2018. While the urban-rural income gap narrowed, this reflected weakness in urban wage growth, which dropped from 80% to 52% of the rate of headline GDP growth – the lowest in our five-year window. Rural wage growth also fell. The economic downturn and its effect on employment are more serious than smoothed headline GDP numbers would indicate.

Supplemental data also show the effect of the economic downturn on employment. New job creation continued to fall (well below GDP now, at a mere 0.7% year-on-year growth rate; see **New Job Creation**). At the same time, the growth of available positions continued to outpace the number of people applying for them, implying that jobs created were not aligned to what local workers were willing or able to do (see **Labor Demand-Supply Ratio**). Reasons for the continued inflexibility of the labor market include the *hukou* system, which still prevents qualified applicants from relocating to fill new jobs, while local candidates often lack the skills that positions require. Low-skilled jobs are eliminated by technological change, and high-skilled jobs require new talents.

The government is not spending enough on worker training and unemployment benefits to address these challenges. Fiscal expenditures on social welfare are decelerating (see **Social Spending**). Government social spending as a percentage of GDP declined in the first half of 2018; while this stabilized toward the end of the year, it was still 11% of GDP lower in 4Q2018 than in 4Q2017. This is partly a side effect of the deleveraging campaign to cut local government and corporate debt, which causes companies to reduce wages and fire employees and reduces local government tax income for covering social welfare (see **Fiscal Affairs**). In other words, the squeeze on credit growth pared back government assistance precisely as the need for it grew.

Supplemental 1: New Job Creation

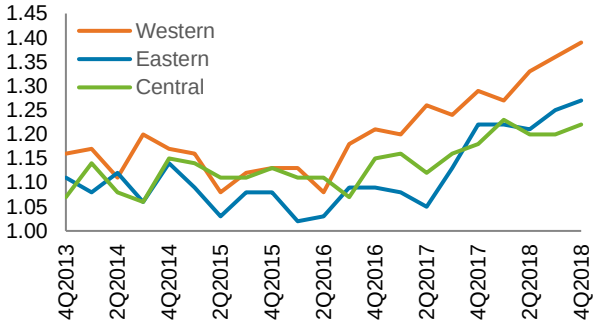
Year-over-year growth



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

Supplemental 2: Labor Demand-Supply Ratio

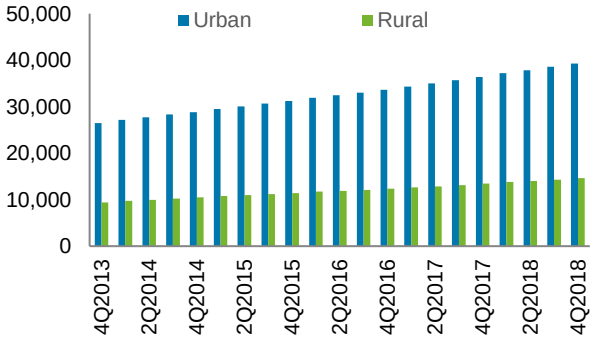
Job openings per applicant



Source: Ministry of Human Resources and Social Security.

Supplemental 3: Rural-Urban Household Income

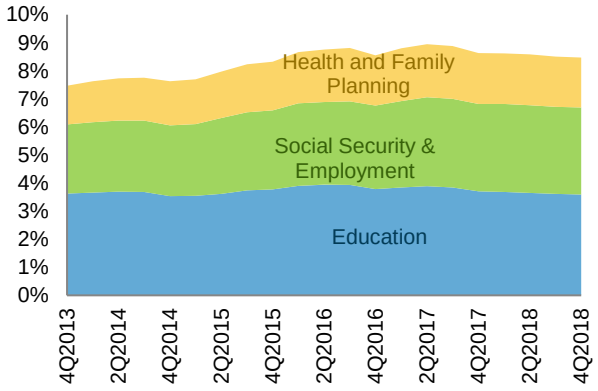
Annualized RMB



Source: National Bureau of Statistics.

Supplemental 4: Government Social Expenditures

4qma, percent



Source: National Bureau of Statistics, Ministry of Finance.

POLICY ANALYSIS

At the March National People's Congress (NPC), Premier Li Keqiang introduced an "employment first" strategy as part of his annual work report on the government, including a target of 13 million new urban jobs this year. These aspirations echo a December 2018 Politburo statement announcing stabilization of employment growth as a 2019 priority. Li's work report offers these solutions: more money for infrastructure projects, reduced corporate taxes and fees, more vocational training support, and an end to labor market discrimination. Measures like increased infrastructure spending are already helping support employment early in 2019, but promised improvements to the structure of the labor market will take years to implement. Relieving cost pressures on businesses, meanwhile, has important trade-offs. Larger than expected tax cuts in the context of limited central-local fiscal reform (see **Fiscal Affairs**) mean less funding for local governments to spend on social welfare, continuing the trend of falling social welfare allocation described in our data review for this period.

At the NPC, Premier Li also announced that mandatory corporate pension contributions would be reduced to 16% of employees' salaries from the current 19%–20%. The reduction was meant to reduce employee-related expenses, but it was also in part a recognition that companies were already paying below statutory rates, a gap that local governments have struggled to fill. Indeed, the government pension fund suffered a 10% shortfall in 2017. A central government pension coordination fund was set up in 2018 to help bridge the deficit, but the RMB 61 billion ($9 billion) dedicated so far is insufficient.

Authorities have made a similar trade-off with regard to China's social security fund, which is supposed to provision not only pensions but also old age, medical, and unemployment insurance. Beijing has backed off a planned merger of the social security and tax administrations, which would have made contribution collection from companies more efficient, in response to corporate concerns about the higher employment costs that would result from stricter enforcement (see **Winter 2019** edition). In 4Q2018, there were no clear measures to put the social security fund on a sustainable footing.

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.

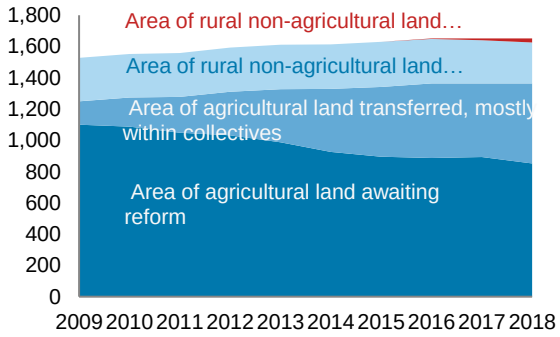
- Rural agricultural land reform is progressing faster than rural nonagricultural land reform: revisions to the Land Management Law, which governs rural residents' rights to rural nonagricultural land and the scope of lawful land requisition by the government, were released for public comment in May 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 primary indicator 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, as center-local political impediments are unsolved. While Beijing has made some progress in consolidating rural agricultural land for farming, the goal of offering rural nonagricultural land on open markets has barely moved. Reform is key to building rural incomes and local economies as slower national growth becomes normal, but marketization remains hostage to state dependence on land transfer revenues.

- We emphasize rural nonagricultural land because it is not subject to special state concerns about food self-sufficiency. Some small pilots are underway, but our data show that the government has "reformed" just 0.1% of rural nonagricultural land.

- At the March 2019 National People's Congress (NPC), leaders again committed to land reform but put forward no compelling new policies.

THIS QUARTER'S NUMBERS

We track whether rural nonagricultural land is being freed for market sale to gauge whether land reform has become a reality in China. Our indicator shows it has not. Most rural nonagricultural land remains dominated by the state, with no clear prospect of being liberalized any time soon.

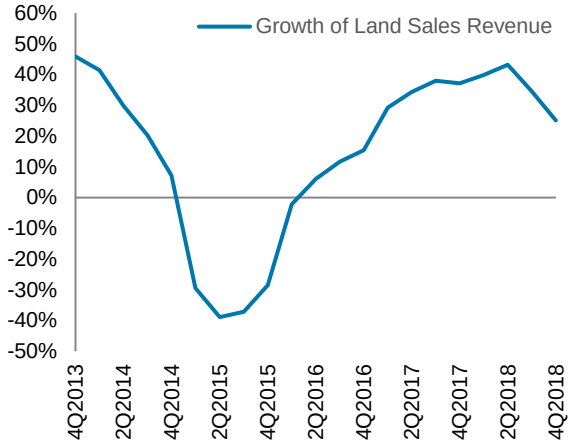
Several small rural nonagricultural land reform pilot projects continue, with some gaining traction since our last review. But the total amount of land affected is minute according to all available (admittedly spotty) data, and progress in selling land has been painfully slow. In December 2018, the State Council announced the latest results for the three types of rural nonagricultural land reform pilots underway in 33 counties around the country. Under the pilot allowing rural families to directly sell land into urban markets, a total of 90,000 mu (14,826 acres) of land were transferred via normal market means under this program since its launch in 2015 through the end of 2018, for RMB 25.7 billion ($3.8 billion), a sharp increase from the reported 20,000 mu (3,295 acres) transferred under the program as of 2Q2018. This increase is most likely the result of a comprehensive stocktaking of progress at year-end, rather than more rapid land transfers in the second half of the year. Selling 90,000 mu of land in four years is far below expectations set for this pilot program to be a more substantive reform push when the government announced the effort in 2015.

Adding data for the two other rural nonagricultural land reform pilots: 180,000 mu (29,653 acres) of rural land acquired by the government at market prices and 84,000 mu (13,838 acres) of rural property land repurposed for other uses, together 354,000 mu (58,317 acres) have been "reformed." This is 0.1% of the 280 million mu (46 million acres) of rural nonagricultural land potentially eligible to be transferred by market means in China today.

The biggest obstacle to real land reform is that local governments remain reliant on land sales for revenue. Allowing rural residents to sell their land directly would take "rent" away from local governments, which today are able to acquire land at low prices and sell it at much higher prices in urban land markets. Local government proceeds from these sales (**Land Requisition Financials**) are falling, down to 25% year-on-year (yoy) growth in December 2018, from 32% in September, just as overall land sales for property development are falling sharply (see **Fiscal Affairs**). This is a worrying sign for China's real estate market and for this important source of government revenue: 24% of local government revenue came from land sales in 2018, the same as in 2017 and up from 17% in 2016. As sources of revenue dry up, local governments grow less inclined to land reform, not more so.

One trend previously flagged as promising was rising rural resident property income. We argued this might be attributable to rural *agricultural* land reform, where the government has made more progress than in nonagricultural land (as shown in our primary indicator). Yet rural property income growth slowed to 9.1% in 4Q2018, down from 12.8% in the previous quarter and the lowest in two years. This probably results from the deleveraging effort, which slowed credit growth to rural agricultural activities particularly in poorer and more agrarian provinces (see **Rural Credit**). It is also consistent with the general slowdown in wages we see across the country as the economy slows, as described in our **Labor** assessment. If credit rebounds in coming quarters, rural property income may rebound as well, though this line item will remain a small share of rural incomes until the government more fully liberalizes local land markets.

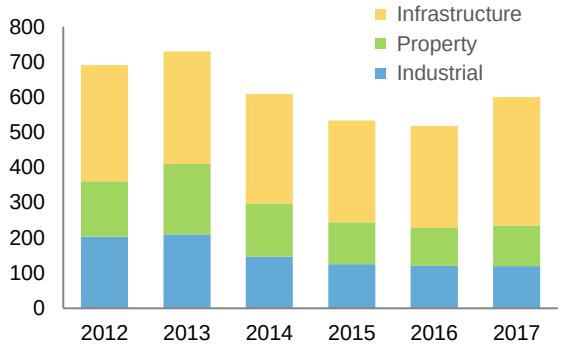
Supplemental 1: Land Requisition Financials
Year-over-year, percent



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

Supplemental 2: Urban Land Supply by Use

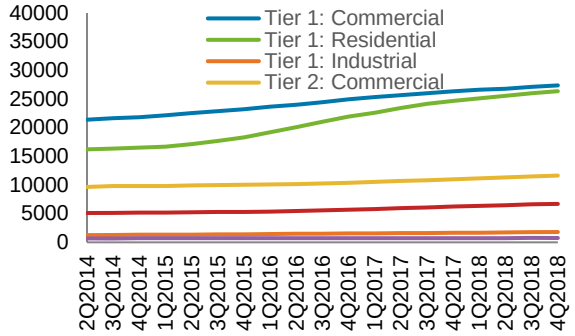
Thousand Ha



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

Supplemental 3: Urban Land Prices

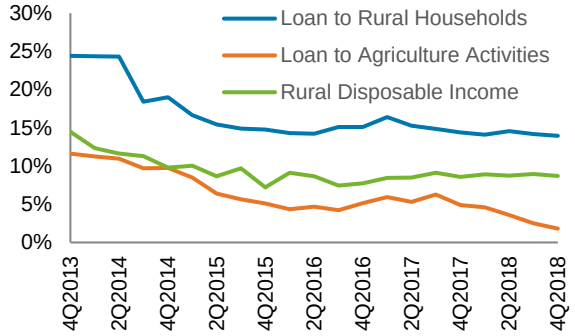
RMB per square meter



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

Beijing has not introduced new thinking on liberalization of rural land markets to address the limits of progress over the past half-decade. Local government resistance remains a major obstacle. During the National People's Congress in March, Premier Li Keqiang did promise to accelerate rural land reform, including by expanding pilot programs and "marketing rural collective land for development purposes." However, Li put forward no specific new initiatives in these areas beyond expanding existing pilots for rural land requisitions—which the government already promised to do but had repeatedly delayed in 2018.

In late February 2019, the Communist Party and State Council jointly released Document No. 1, the annual first directive from the government that always addresses rural development issues. Again, this was hopeful but nothing new. Beijing promised to facilitate rural agricultural land transfers and large-scale farming and to develop a more vibrant market to allow farmers to mortgage their land in exchange for capital. It also promised further reform to rural nonagricultural land policy, but progress is contingent on first revising relevant laws – presumably including the Land Management Law, which has not moved forward since Beijing released it for public comment in May 2017. The document also urged local governments to spend more of the land transfer revenue they take in on rural development, which is a welcome aspiration, but the 2013 Third Plenum goal was to reduce local government reliance on this source of revenue, not to put it to better use.

Meeting notes from the annual Central Rural Work Conference held in late December underscore our skepticism on the 2019 land reform outlook. According to public reporting, the MoARA identified its key land reform tasks for the year as "finishing land registration work and stocktaking rural assets," work that was meant to have finished in 2018, and "carefully promoting reform of rural property land"—a vague assertion. This indicates (perhaps unsurprisingly) caution within China's top land policy agency on the prospect of deeper reform.

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 (similar to those used in the 1990s) involving the sale of minority shares to private firms. These piecemeal efforts continue today. However, none of these measures has been sufficient to reshape SOEs' incentives in line with market principles or redefine their role within the economy.

- In September 2015, the State Council published a new set of "guiding principles" for SOE reform. The document was more conservative than expected. Rather than allowing the market to decide the future of SOEs, the State Council proposed utilizing market mechanisms to make SOEs bigger, stronger, and more efficient, while maintaining control by the government.

- The 2015 guiding principles reiterated a 2013 Third Plenum goal to transform the government's role in managing SOEs from "managing assets" to "managing capital." The plan was to allocate state capital toward strategic industries and reduce direct intervention within SOEs' day-to-day operations, thereby improving efficiency. The government also stated that it would strengthen SOE corporate governance but made clear that it viewed Communist Party supervision as critically important.

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

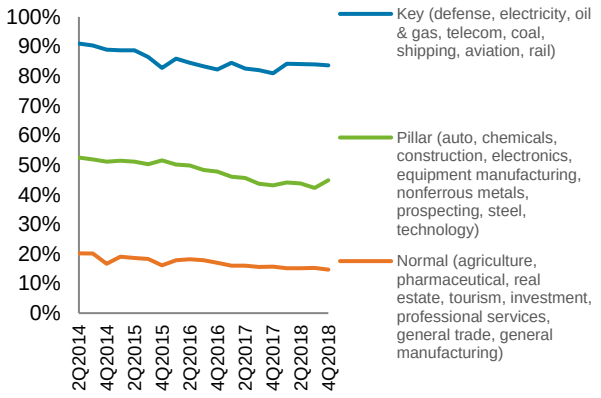
METHODOLOGY

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

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Share of SOE Revenues in Different Industry Categories

4qma, percent



Source: Bloomberg, Rhodium Group.

- SOE reform is not moving materially forward and our score remains negative — the weight of SOEs in China's industrial sectors was unchanged or increased modestly in 4Q2018 across all industry categories. Even a trend of reduced SOE presence in pillar industries has now reversed.

- Data do show private firms are borrowing more and growing again, at least for now, as leaders respond to an anxious public backlash over deteriorating conditions for the private sector.

- Reform debate is still constrained by ideological commitment to a strong state presence: officials mostly reiterate existing policies while the economic risks of inaction rise.

THIS QUARTER'S NUMBERS

The continued massive role for state-owned firms in the economy remains one of China's most pressing reform challenges. At the 2013 Third Plenum, Beijing planned to reduce state influence in commercial industries. But we do not see a smaller role for the state in any of the three major industry categories assessed in our data.

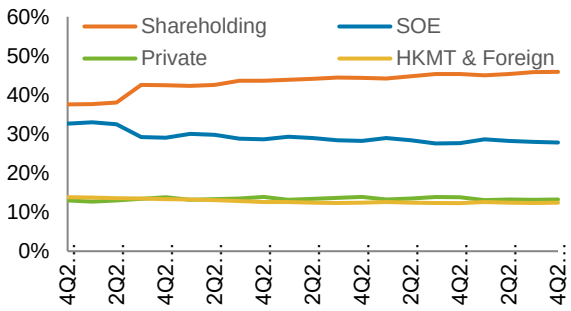
Based on annual reports of listed Chinese companies, we calculate that SOEs generated 14.7% of revenues in normal industries, those for which Beijing has not offered a strategic rationale for state dominance and therefore should be suited to market competition. This number is only slightly lower than last quarter despite Beijing's repeated promises to accelerate reform. Our data also show that SOE revenue shares in pillar industries, which Beijing says are economically strategic to future competitiveness, are now increasing — reversing the trend of the past three years. The reversal was particularly notable in construction industries, as Beijing turned to SOEs and infrastructure projects again late last year to stabilize the economy. SOE revenue shares in key industries remain high, at around 84%, and have little chance of shrinking as these are the sectors Beijing views as most directly related to national security.

In the past two Dashboard editions, we noted that China's private sector was shrinking and its state sector growing, as policymakers emphasized the importance of state firms and deleveraging efforts reduced capital available to private interests. At least for the moment, this has reverted back. Policymakers called for increased private sector support in late 2018 and eased monetary policy to drive growth. This improved private sector credit conditions, primarily via short-term working capital loans. Private firms were able to borrow more in 4Q2018, driving a continued rise in private sector leverage relative to SOEs (see **SOE Leverage**). The return on assets for private firms also improved slightly to 7.1% in 4Q2018 from 7.0% in 3Q2018 (see **SOE Return on Assets**), likely a result of tax cuts and lower mandatory pension contributions.

Can this bounce in private sector activity last? We are not overly optimistic, because the improvement is mostly short-term borrowing. As economic momentum accelerates in 2019, the central bank appears to be backing off monetary easing, which could translate into higher money market rates and higher private sector borrowing costs by the middle of the year. Despite renewed borrowing at the end of 2018, the private share of industrial assets held steady at 13.2%. This means SOEs are growing as well (see **Industrial Assets by Ownership**). If interest rates do start to rise, SOEs will benefit more because of their easier access to capital, as was the case in 2017–2018. Taken together, we expect the private recovery to be fragile and shallow unless leaders take more decisive actions to limit the activities of SOEs by reducing their political advantages.

Supplemental 1: Industrial Assets by Ownership

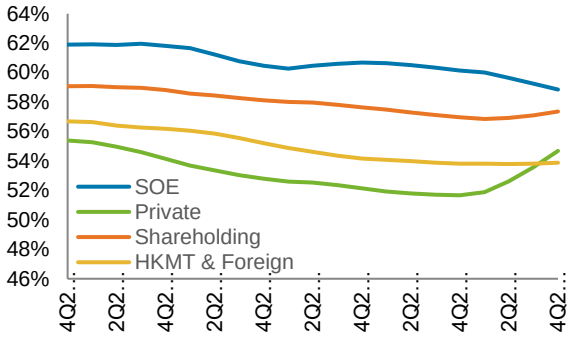
Percent



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

Supplemental 2: SOE Leverage

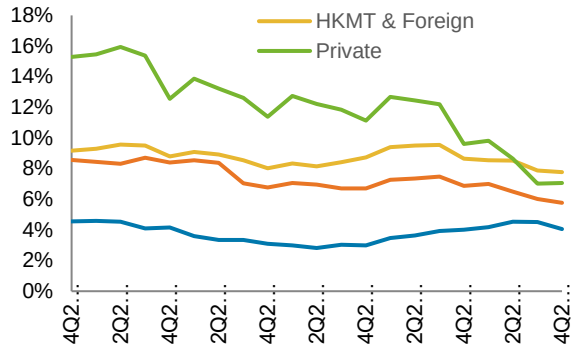
12mma, percent



Source: Ministry of Finance, Rhodium Group.

Supplemental 3: Return on Assets

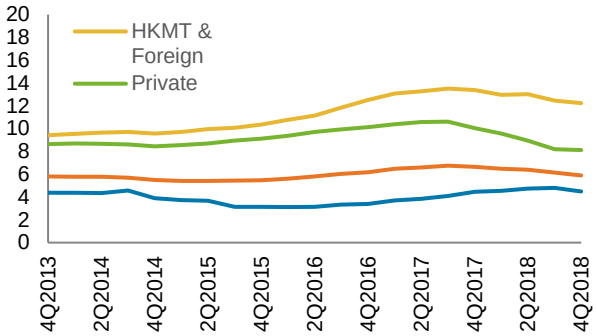
Percent



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

Supplemental 4: SOE Interest Coverage Ratio

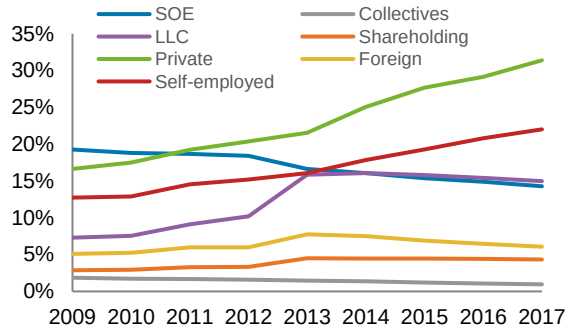
Profit to interest ratio, 12mma



Source: Bloomberg, Rhodium Group.

Supplemental 5: SOE Share of Employment

Percent



Source: National Bureau of Statistics, Rhodium Group.

POLICY ANALYSIS

Pruning state-owned firms would improve internal resource allocation and reduce international pushback. But leaders offered no compelling new reform designs this period. At the moment, leaders are more intent on influence over economic outcomes than greater efficiency and competition.

At the March National People's Congress (NPC), Premier Li Keqiang did make an encouraging promise in his annual work report to better "balance the relationship between government and market." This was the first time in five years that this phrase was prominent, suggesting that policies concerning the competitive environment and the treatment of SOEs are at least up for discussion again (see **Competition** section). However, Li has yet to advance any substantive new measures. His report merely promised to continue the mixed ownership trials for state-owned firms already underway and improve SOE corporate governance. Li did commit to accelerated restructuring for oil, electricity, and railway SOEs, but these plans are primarily about the regulation of SOE monopolistic pricing power rather than reducing their presence in these sectors overall.
Also during the NPC, a spokesperson for the National Development and Reform Commission (NDRC) stated that private investors would be able to acquire controlling interests in normal commercial SOEs, consistent with 2013 reform goals. But the NDRC did not propose any new details, such as making explicit which SOEs would be considered normal commercial SOEs or giving private investors assurances that they would be able to control these firms after acquiring a majority of shares.

There was one area of SOE reform progress during the NPC, but this ironically reflected the government's intention to continue relying upon state firms for the foreseeable future. In its 2019 budget released on March 6, the Ministry of Finance (MoF) said that it would increase SOE dividend payments by an average of 16% in 2019, up from 7.7% growth in 2018. Requiring SOEs to pay more dividends to the state was an explicit 2013 Third Plenum commitment, so this does represent progress. But our analysis shows that 70% of these dividends are then *reinvested back into SOEs* themselves. So this policy will have little impact on the overall economy and may actually benefit many SOEs. In fact, squeezing more dividends out of SOEs could prove counterproductive to the Third Plenum reform objectives if policymakers try to maximize SOE profits at the expense of other private market players.

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

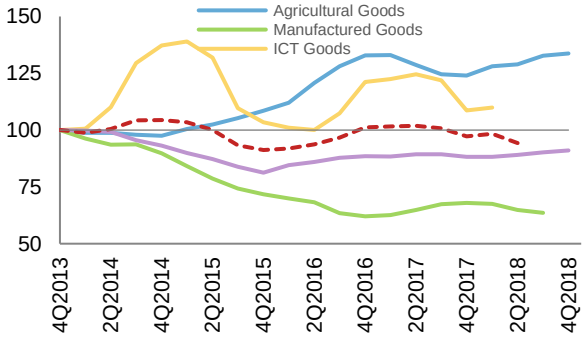
To gauge trade liberalization progress, we assess the change in China's imports of a selection of highly protected goods and services using a composite trade liberalization index (CTLI). Scores higher than 100 indicate a growing role for these imports relative to GDP since 2013; lower scores indicate 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 give trade policy reform a positive score this quarter, up from negative previously.

- Our data show a partial improvement in China's openness to services trade, but no structural shift toward higher value-added and consumer-driven imports. Increased tariffs on trade with the United States started to reduce China's trade flows in both directions in 4Q2018, complicating the analysis of broader trade patterns.

- Beijing cut tariffs and taxes to mitigate the effects of the trade war and support domestic economic recovery. While U.S.-China trade negotiations provide an opportunity for Beijing to converge with international trade rules, only piecemeal changes have been made so far and a recent escalation of bilateral tariff measures is not encouraging.

THIS QUARTER'S NUMBERS

For the third consecutive quarter, our quantitative analysis of China's trade policy has been hindered by missing data concerning China's goods trade, 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. However, Chinese customs officials have indicated that missing data will become available again this June, meaning we should be able to analyze it later this year.

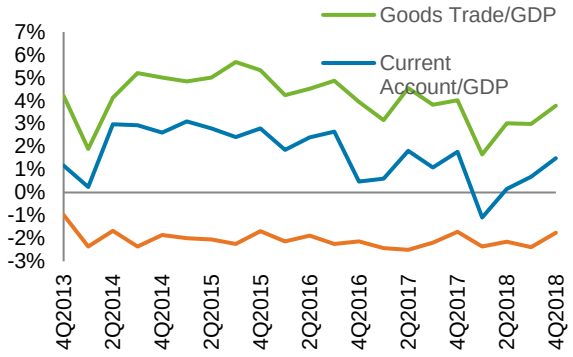
From the subset of data that was officially reported, we see partial improvement in opening of closed-off trade channels. The two sub-indicators we *were* able to update show China's protected agricultural imports rising, and services imports continuing to increase gradually (though they are still below the level of six years ago during the 2013 Third Plenum). Detailed services trade data also indicate China is becoming more open (see **Services Trade Openness**). Both services imports and exports rose steadily in 2018. Outside of tourism, which can disguise financial outflows from China, services imports rose 12.7% in the second half of 2018, while imports of telecom and other information services rose more than 20% year-on-year (yoy) each quarter in 2018. The "other business services" category led export growth, which includes research & development, consulting, architectural and engineering services, and other trade-related services.

While some progress on opening to services trade is apparent, structural adjustment toward higher value-added and consumer-driven import trade is still elusive. **External Trade** balances show China's current account-to-GDP ratio declined in 4Q2018, led by the smallest goods trade-to-GDP ratio for the fourth quarter of any year since 2011. The narrowing of China's current account surplus is not just a trade phenomenon; it is also aligned with financial liberalization as foreign capital plays a greater role in meeting China's capital needs. Indeed, China's current account has already shrunk considerably, from its near-term peak of 2.8% of GDP in 2015 to 0.4% in 2018, and capital inflows increased strongly in 2018 relative to the low levels in previous years.

In the coming quarters, more immediate factors like trade war pressures and commodity prices will likely determine whether China's current account surplus fluctuates between a small surplus and a small deficit. This quarter, goods exports and imports rose by their smallest margin since 2016, with import growth driven by oil imports while export growth was powered by China's traditional manufacturing exports. In addition, China's imports and exports both suffered in November and December, likely related to the impact of bilateral tariffs imposed between China and the United States. **Structural Change in Goods Trade** shows that the shift to higher value-added trade — indicated by the level of imports processed in China relative to total exports — has not progressed meaningfully since 2016.

Supplemental 1: External Trade

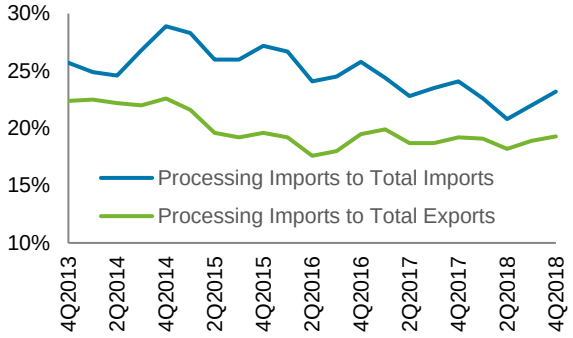
Percent



Source: State Administration for Foreign Exchange.

Supplemental 2: Structural Change in Goods Trade

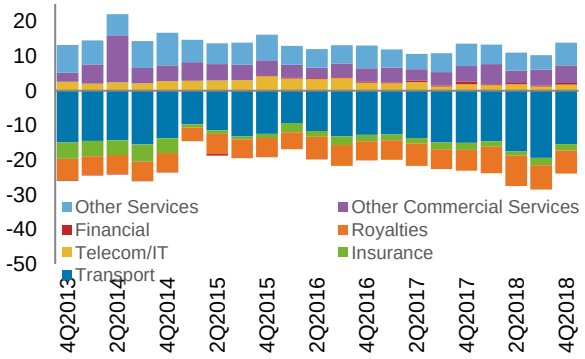
Percent



Source: General Administration of Customs.

Supplemental 3: Services Trade Openness

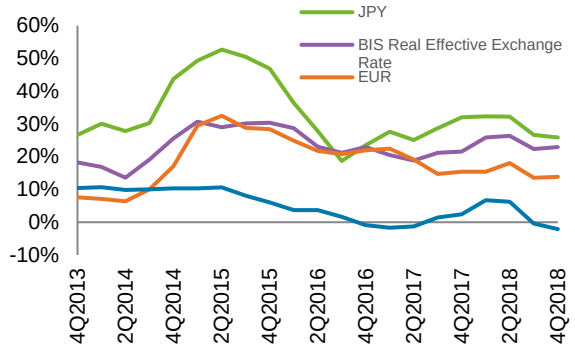
USD Billion



Source State Administration of Foreign Exchange.

Supplemental 4: Exchange Rate Fluctuation

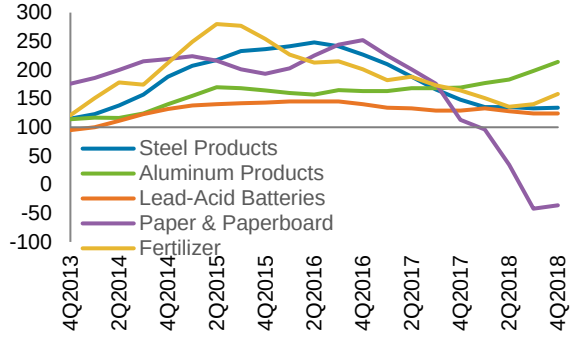
Percent



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

Pressure from trade negotiations with the United States and growing complexity in the international trade environment elevated the importance of trade policy for China's leaders this period. At the National People's Congress (NPC) in March, Premier Li Keqiang named managing the "relationship between domestic and international issues" a top priority in achieving government goals and targets for the year, signaling growing attention to global pushback against China's trade and investment policies and practices.

For the most part, annual work reports released by Premier Li and the National Development Reform Commission at the NPC reiterated the same vague trade policy objectives of past years without specifying plans or timelines for implementation, indicating little movement toward more fundamental reforms. These goals — laudable in principle but lacking in implementation — include supporting the upgrading of processing trade; improving the import mix and actively expanding overall imports, especially in advanced technology and equipment and key resources; creating a fair and impartial environment for domestic and foreign companies; and facilitating WTO reform.

Beijing regularly tweaks tariff policy to support macroeconomic needs and industrial development goals, and the January 2019 round of tariff cuts was no exception. These reductions also support the stated reform goals of broadening trade openness and increasing imports, following earlier 2018 tariff cuts on 1,449 goods in May and 1,585 goods in September. But the growing costs from the trade war with the United States shaped the ways in which China opened its economy this quarter, likely accelerating some implementation. In late December, the Ministry of Finance (MoF) announced revisions to provisional tariff rates effective January 1, reducing or removing tariffs on 706 products to meet various policy goals. Import tariffs were reduced for textiles and pharmaceuticals as well as higher value-added industrial goods, including batteries for new energy vehicle engines, aircraft engines, and welding robots for auto manufacturing. Starting July 1, Beijing will push through the fourth round of most-favored nation (MFN) tariff rate cuts for information technology imports, covering 298 items. The MoF also implemented previously agreed-upon tariff reductions for a number of bilateral and multilateral FTA partners. Beijing's utilization of FTA mechanisms to reduce trade barriers is important in the long run for the trade reform agenda, but also serves to deepen links with alternative trade partners amid higher U.S. tariffs. Beijing also reduced tariffs on alternative feed imports, reflecting trade war pressures as U.S. soybean imports are subject to tariffs.

At least so far, U.S. pressure has not succeeded in achieving *fundamental* changes to China's trade policies; however, Beijing did make modest gestures in the context of ongoing negotiations. For example, Beijing extended its temporary suspension of retaliatory tariffs on U.S. autos and parts, after the White House delayed escalation to 25% tariffs on $200 billion of imports from China (though it later took this action anyways, as discussed below). Chinese companies reportedly resumed occasional purchases of U.S. soybeans, sorghum, and oil throughout the first four months of 2019. Beijing addressed some of the core U.S. concerns within the Section 301 case — forced technology transfers and intellectual property theft — in late April when the NPC Standing Committee passed changes to the Trademark Law and Anti-Unfair Competition Law (see the **Competition** section). Beijing also passed a new Foreign Investment Law in early 2019, which will take effect in 2020 and which guarantees "pre-establishment national treatment" for foreign companies (see **Cross-Border Investment).** Ultimately, to be considered effective these developments will necessitate transparency around implementation and enforcement.

Will U.S. pressure ultimately lead Beijing to undertake more concerted trade policy changes? Bilateral negotiations do present an opportunity for reformers in China to advance their case for further liberalization, but whether they will succeed is still unclear. As of the drafting of this Dashboard edition, U.S. President Donald Trump raised tariffs on $200 billion of U.S. imports from China already targeted under its

Section 301 case from 10% to 25%, and initiated the procedures to levy 25% tariffs on the remainder of U.S. imports from China if China retaliated. Beijing did so by increasing tariffs on $60 billion in imports from the United States, prompting the Office of the U.S. Trade Representative to schedule a hearing and comment process in June to evaluate tariffs on approximately $300 billion worth of additional imports from China. These actions make what was already a difficult negotiation more complicated, particularly as outstanding questions like how Beijing's reform commitments will be enforced, whether and how quickly bilateral tariffs will be reduced, and whether Washington can continue to use unilateral tools to respond to China's noncompliance cloud the outcome.