

China Dashboard Summer 2019 Update

September 2019

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



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

Summer 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

The once-unimaginable scenario of China decoupling from major parts of the world economy is starting to appear realistic. It is useful to recall how this started. For China, engagement with the capitalist world was initially about earning a capital surplus to permit investment at home and acquire technology from abroad. Beijing became almost too good at this game, amassing foreign currency (and thus foreign government bonds). In recent years, Beijing was forced to relax its hoarding fixation. Not only was there no marginal benefit, but China's twin surpluses were becoming a liability, breeding overdependence on foreign bond markets and resentment from the United States and other countries for its never-ending trade deficits. Beijing loosened capital account controls in 2014 and, lately, its firm hand on the value of the currency, which also stabilized the balance of payments.

The era of certainty about net capital inflows into China is over. The trade surplus has thinned as a share of gross domestic product (GDP), even in absolute value terms. After capital controls were loosened in 2014, \$1 trillion in foreign exchange (net) left the country in about a year and a half, with the next trillion in line behind it, leading to controls being reinstated. The door is being opened wider to global portfolio capital, but it is not clear that capital wants to come in. Multinational corporate direct investors, long a mainstay of China's domestic investment scene, are publicly diversifying into Vietnam, India, and other economies.

Beijing now has to contemplate a world in which trade is not in surplus and capital flow pressures are skewed toward the outbound side. The readiness of middle-class Chinese citizens to switch out of property-heavy domestic assets to a more diversified global portfolio exceeds the appetite of global savers to bring their wealth into the politically fraught world of Beijing's socialist market system.

This picture—hardwired logic behind outflows but foreign investor hesitation on the inbound side—reawakens China's anxiety about capital shortfalls sleeping just beneath the complacent surface.

That is the background against which we discuss investment opening announcements in the first half of 2019 in this edition of the China Dashboard. In our **Cross-Border Investment** assessment, we detail a new Foreign Investment Law approved in March and a new “negative list” approved in June to open more space for foreign investment. In May, the banking regulator announced removal of equity caps and asset requirements on foreign investment in banks and branch networks. For the securities industry, regulators approved majority ownership in joint ventures, with Premier Li Keqiang promising to remove all equity restrictions by 2020. Foreign ownership caps for insurance companies will also be lifted by 2020, according to a July 20 announcement. All this represents a concerted effort to attract foreign capital.

But partial financial account opening will not overcome investor hesitation. Portfolio inflows so far have had a short-term, cyclical flavor, and outflow pressures remain high and are rising. So far, index inclusion schemes like MSCI have brought active capital investments sensitive to short-term macro fluctuations, and not the long-term buy-and-hold, passive funds that nations crave. In the on-again, off-again U.S.-China trade talks, Beijing was strikingly eager to see Washington accept its offer of

accelerated financial sector opening. This left some skeptics wondering: what if Beijing opened the door and no one, or not many, walked through?

Beijing’s ultimate challenge is ensuring that the trillions of dollars in domestic savings that it is eager to diversify abroad are balanced by a similar magnitude of foreign capital willing to invest in China over the long term. Past GDP growth was an irresistible lure to foreign investors, but that growth depended on Beijing’s constant intervention, data smoothing, and macro-engineering, along with a foreign tolerance for an uneven commercial playing field which has now become exhausted.

The risks of poor investment returns are now made *more* complicated by the advent of a less managed, more market-determined renminbi exchange rate, if the People’s Bank is to be taken at face value: on August 5, 2019, the authorities stopped intervening to keep the currency above a symbolic level of 7 to the dollar. The era of an assured, stable currency is ending, both because of the financial realities that China has built up at home over a decade, as well as because of the policy tensions with Washington. Going forward, foreign investors need to consider exchange rate risks much more carefully.

The most revealing aspect of Beijing’s exchange rate move was not the extent of weakening (a mild 1%–2%, compared with 10%–15% swings from June to August 2018) or that it broke through the 7-to-the-dollar barrier, but rather that the central bank [explained it](#) in terms of China’s attractiveness to global investors:

China is the only country among major economies that has kept monetary policy in a normal state while developed economies including the U.S. and Europe are currently all shifting to an easing bias. The valuation of Yuan-denominated assets is still relatively low, and therefore more stable—this should attract global funds because of these low valuations.

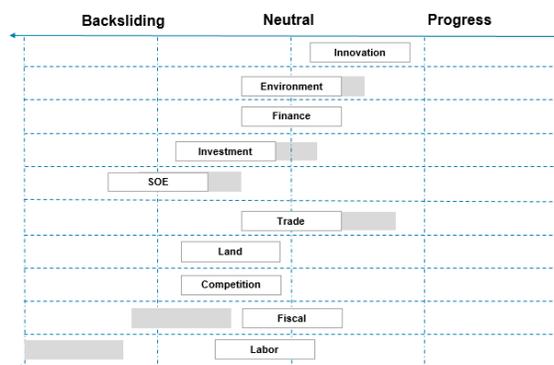
The People’s Bank of China spokesperson was not only trumpeting the currency weakening as an opportunity to buy Chinese assets at a discount, but also, by implication, suggesting that Beijing would set monetary policy to protect international investor wealth. Whether it does so will be easily tested and observed by this Dashboard and other indicators, so this is a bold claim revealing a strong concern with attracting foreign capital.

For all China’s newfound potency in the international arena, its balance-of-payments resilience has not been

tested in slow growth circumstances. Those conditions are approaching, and economic leadership is clearly thinking a lot about them, as reflected in the currency policy statement.

China’s economic growth continues to fall, following a declining pattern since 2010. The most recent second-quarter growth of 6.2% was the slowest since 1992, when official quarterly records were first published. This, combined with heightened international scrutiny on China’s economic practices, sees their political economy at a crossroads between President Xi Jinping’s political predilection for a state-centric economic growth model and the economic reality of private sector-led growth. This contradiction raises uncertainty around Beijing’s policy support for the private sector, contributing to low private sector business sentiment through official and unofficial measures among firms who have grown distrustful of Beijing.

Summer 2019 Net Assessment: Quarterly Movement in 10 Areas



The Indicators

The 360-degree perspective on China’s economy offered by the Dashboard indicators makes clear why the abundance of piecemeal financial opening described earlier will not necessarily ensure a balance in capital flows. Beijing is pulled between keeping interest rates high enough to attract investors and keeping them low enough to avoid nationwide bankruptcies. The recent failure of several banks (Baoshang and Jinzhou) shows how potentially close to the edge of a banking crisis China is.

Myriad institutional reform impediments are evident. Equitable regulation of foreign and non-state firms alongside state enterprises is far off (as seen in our competition policy indicators); data blind spots are persistent (trade policy, legal decision reporting); financial globalization is shrinking instead of expanding (cross-border investment); and deference to markets in

financial intermediation is falling by the wayside, with policy pressure to lend for stock trading and pressure not to lend for mortgages.

Our indicators point to reform slack in these critical areas. In our **Competition** assessment, we see that foreign-involved mergers are three times more likely to be reviewed by regulators than domestic-only mergers, and enforcement responsibilities are being shifted more to local governments—more often the source, not the remedy, for anticompetitive practices in China. Authorities sought to promote competition policy and intellectual property protection with special courts and transparent legal outcomes. But China is publishing less than 5% of the competition and intellectual property disputes handled each year, and in 1Q2019, courts even removed 400–600 previously published cases per year from their websites. This does not inspire confidence in a fair competitive environment.

One of the most significant obstacles to balanced capital flows is corporate governance reform for shareholders of Chinese corporations, including state enterprises (which dominate equity market capitalization). In 1Q2019, we see an *increase* in the state-owned enterprise share of listed company revenues in “normal” industries, hinting at an expanding state even in areas where Beijing set out to withdraw influence at the 2013 Third Plenum that initiated the Xi-era economic reforms. Despite repeated pledges to reduce state intervention and empower boards of directors at state firms, authorities are ramping up inspections and reporting requirements, creating new obstacles to market-based decision-making.

China’s partial financial and investment opening in the first half of 2019 is positive, though overdue. It is also not sufficient. Pervasive policy challenges such as the ones mentioned above will continue to stymie the capital inflows that Beijing’s currency policy justification expected to attract with lower dollar-basis valuations thanks to a weaker currency. Credible liberalization across the *full* spectrum of policies is needed to move trillions of dollars into China over the long term.

Two policy areas—**Labor** and **Innovation**—did move in a positive direction in early 2019. Both urban and rural workers saw wage growth improving in 1Q2019 from the fourth quarter of 2018; however, most earners saw income grow at a slower pace than GDP, while structural impediments like *hukou* restrictions and government social spending continue to hinder labor mobility. Innovative industries are playing a greater role in China’s manufacturing sector. So far this year, Beijing has

taken steps to marginally reduce market entry barriers, improve the intellectual property regime, and expand capital market access for domestic tech companies, which are positives for innovation but are undermined by lack of progress in the competitive environment.

View from Abroad

These indicators of China’s economic dynamics *should be* the foundation of macroeconomic and geopolitical thinking for China’s national and commercial counterparts around the world. If Beijing is concerned about balance-of-payments shortfalls, as we conjecture, leaders will resist overdue policy adjustments that would nudge them toward current account deficits. China’s technocratic economic officials are pushing policy reforms as much as they can—for instance, interest rate reforms and investment opening—but at this stage, piecemeal measures no longer have as much credibility as they once did. Bolder and more decisive demonstrations of marketization are necessary. Examples might include comprehensive elimination of foreign equity caps for direct investors to remove this channel of forced technology transfer, a significant sell down of state shareholding in the economy, and the definitive restoration of the previously relatively open public debate about Chinese economic conditions and policy options.

In reality, the China conversation in capitals and business centers around the world in late 2019 is based less on China’s economic fundamentals and more on political anxieties, American political brinksmanship, and often a weak grasp of emerging economic facts. The suggestion that Beijing’s withdrawal of policy to *prop up* the renminbi justifies the charge of currency manipulation is the most obvious case in point. The notion that Americans do not pay the price for U.S. tariffs, or that falling inward foreign direct investment makes America stronger, or that Federal Reserve officials are to blame for falling global investor confidence are just a few more.

While recognizing the reality of political and geopolitical risk for markets, the current conversation reinforces the need for as much objective economic analysis as possible on the real state of the Chinese economy, including all its strengths and weaknesses.

Competition

The Story So Far

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

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

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

companies. And it is in the process of revising patent and antitrust laws, ostensibly to strengthen legal protections for companies, although unequal enforcement between state and private firms and between domestic and foreign firms remains a major concern.

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

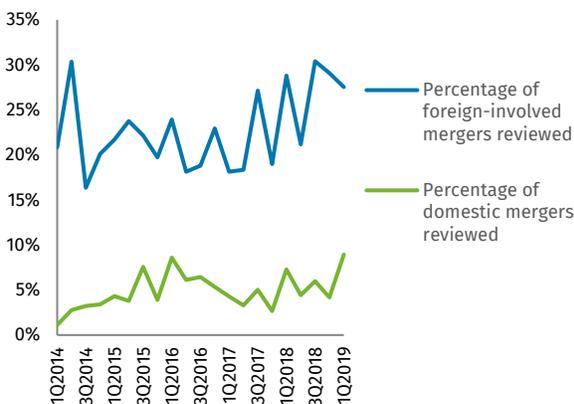
Methodology

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

Quarterly Assessment and Outlook

Primary Indicator: Merger Reviews

4qma, percentage



Source: Ministry of Commerce, Bloomberg, Rhodium Group.

- Our reform score in 1Q2019 remains negative and unchanged as foreign firms continue to be targeted disproportionately in merger reviews.
- Judicial transparency has deteriorated, with courts removing relevant cases from the public record. New business registration is slowing despite Beijing's efforts to lower market entry barriers; high market exit barriers have kept inefficient firms operating, thereby limiting pricing power.
- Leaders are trumpeting "competitive neutrality," but policies to make it a reality are missing. The delegation of antitrust enforcement to local governments is likely counterproductive, as subnational officials are more incentivized to protect special interests than promote fair competition.

This Quarter's Numbers

Our primary indicator shows that foreign companies are targeted disproportionately for merger reviews in China, reflecting an unlevel playing field. In 1Q2019, the State Administration for Market Regulation (SAMR) reviewed 28% of foreign-involved mergers but only 9% of domestic mergers. The difference is smaller than in the previous quarter—when 30% of foreign-involved and 4% of domestic mergers were reviewed—but the 28% chance of review for foreign-involved mergers remains among the highest on record. The increased percentage of domestic merger reviews is mainly attributable to fewer domestic mergers (347 in 1Q2019 compared with 620 in 4Q2018) rather than more reviews (31 in 1Q2019 compared with 26 in 4Q2018).

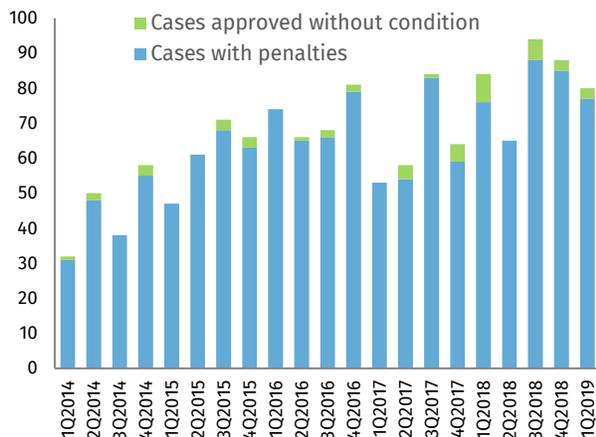
Out of 80 cases that the SAMR reviewed in 1Q2019, 61% involved foreign companies. This share is lower than the 70% reviewed in 4Q2018 but around the average since 2016. The SAMR used these reviews to impose conditions on the merger of two foreign electronics manufacturers, KLA from Silicon Valley and Orbotech from Israel. It has never restricted a domestic merger.

At the same time, China's poor judicial transparency has deteriorated further. Courts publish less than 5% of the competition and intellectual property disputes they handle each year, with significant delay (see **Judicial System Transparency**). In 1Q2019, the courts even removed previously published cases (400–600 cases a year) from their websites. Cases may be removed upon request from involved parties because of sensitive issues like business secrets, but this is the first time we have observed a net reduction of published cases, adding concerns to the reliability and credibility of China's judicial system.

Efforts to lower market entry barriers seem to be flagging. New business registration grew by 7.9% year-on-year in 1Q2019, barely an improvement from 4Q2018, when economic activity was much weaker (see **Market Entry and Exit**). Inefficient firms competing on low prices are not being forced to exit, making the market less attractive for new entrants. Our **Pricing Power Index** indicator shows that listed companies in China subsist on much lower margins than their Organisation for Economic Co-operation and Development peers on average. Listed SOEs do not even charge enough to cover their production costs and investments, and they still enjoy lower average capital costs (9.2% in 1Q2019) than listed private firms (10.3%). Pricing power for both SOEs and private listed companies improved slightly in 1Q2019 as the economy rebounded temporarily, but not enough to attract a substantial number of new entrants, especially as access to capital remains skewed toward SOEs.

Supplemental 1: Results of Merger Reviews

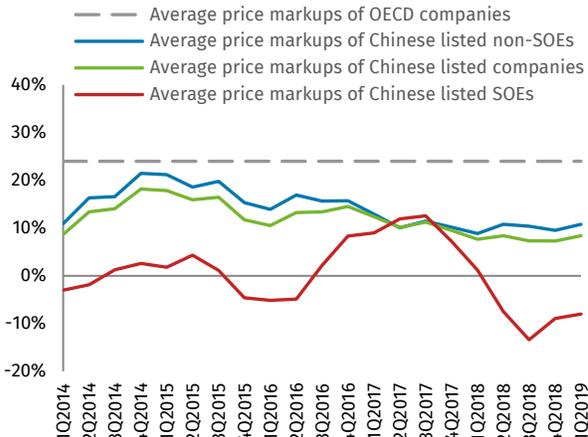
Number of cases



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

Supplemental 4: Pricing Power Index

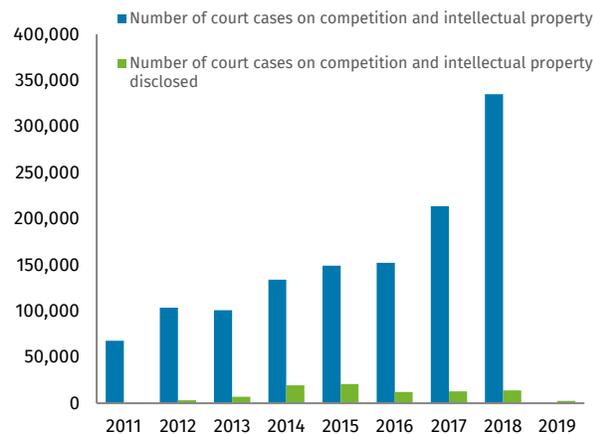
Percentage



Source: Bloomberg, Rhodium Group.

Supplemental 2: Judicial System Transparency

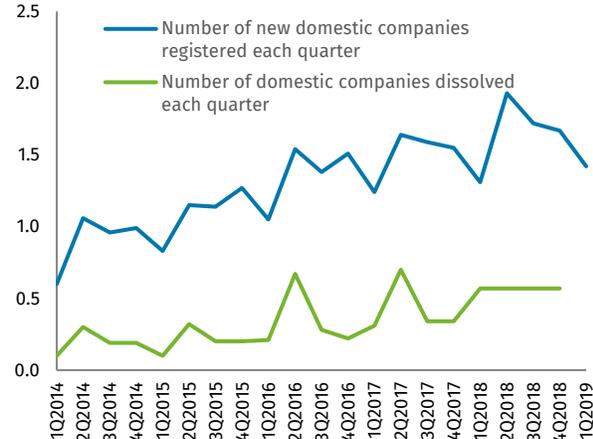
Number of court cases



Source: Judgements Online, Supreme Court.

Supplemental 3: Market Entry and Exit

Millions



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

Policy Analysis

Despite Premier Li Keqiang’s promotion of competitive neutrality for state-owned and private firms at the NPC in March (see the **Spring 2019 edition** for further discussion), policy developments are not moving closer to this goal. In May, the SAMR chaired a national antitrust work conference and identified 17 work priorities, none of which concerned new measures to ensure neutral treatment for firms of different ownership. It is common to hear officials use the term “competitive neutrality” to defend SOE interests abroad rather than to limit their privileges at home.

Beijing acted to strengthen antitrust enforcement on July 1 (after the 1Q2019 review period), with the SAMR publishing three regulations to be effective on September 1. These regulations detail the antitrust enforcement procedures for monopoly agreements, abuse of market power, and administrative monopoly (i.e., government intervention in the market via anticompetitive policies, discrimination in procurement, etc.). While these regulations are part of the consolidation of previously divided antitrust enforcement powers under the SAMR following the government restructuring plan announced in March 2018, they will likely be counterproductive. They authorize local governments to enforce antitrust rules in their own jurisdictions, while the SAMR will only oversee cases it sees as needing its intervention, such as cross-province cases, especially complex ones, and influential cases.

This change marks a significant departure from practice over the last two decades. Antitrust enforcement previously was centralized, with local governments acting only with specific central authorization. Now local

governments are empowered to act at will. In practice, local officials generally have neither the specialized knowledge nor the political willingness to act to foster competition. Local governments and SOEs more often are the *source* of anticompetitive practices.

Two other developments during the review period illustrate the persistent gap in achieving fair and nondiscriminatory antitrust enforcement. As discussed in our **SOE Reform** assessment, antitrust authorities remain silent on central SOE mergers (especially the merger of shipbuilding SOEs), despite the implications for domestic and global markets. In addition, Beijing announced the creation of an “Unreliable Entity List” in response to Washington’s placement of Huawei on the U.S. Department of Commerce’s “Entity List.” Beijing claimed that its Anti-Monopoly Law (AML) was grounds for this action (along with the Foreign Trade Law and National Security Law); however, it seems that Beijing is using the AML to pursue objectives beyond safeguarding competition.

Cross-Border Investment

The Story So Far

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

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

portfolio investment and currency conversion by households.

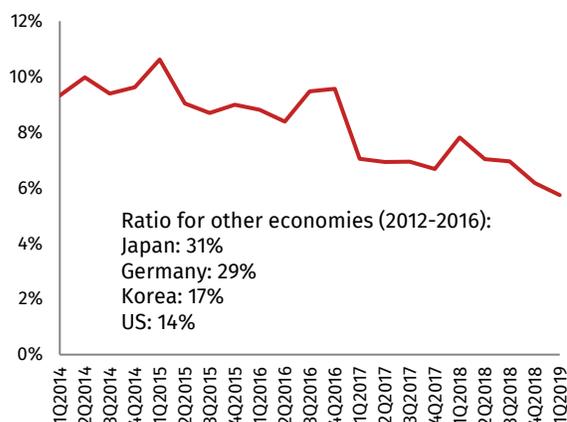
Methodology

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

Quarterly Assessment and Outlook

Primary Indicator: External Financial Liberalization

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



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

- Our assessment remains negative this quarter. Gross cross-border capital flows as a percentage of GDP declined to the lowest level in the past decade, and capital inflows have not picked up substantially despite fewer FDI restrictions and China’s inclusion in global equity and bond indices.
- Data indicate that international use of China’s currency has not expanded, and capital controls remain intact, while the central bank continues to stabilize the exchange rate.

- The trade dispute with the United States is testing Beijing’s commitment to opening its financial sector. Despite new liberalization of inflows, broader structural impediments remain unchanged and other new policies add to uncertainty. Moreover, capital outflow restrictions remain tight.

This Quarter’s Numbers

China’s investment engagement declined in 1Q2019, with our primary indicator dropping to the lowest level of the last decade (see **External Financial Liberalization**). Gross capital flows in both directions picked up slightly, to \$182 billion in 1Q2019 from \$148 billion in 4Q2018, but as a proportion of China’s economy, they dropped to 5.74%. This is a disappointing result in light of China’s ostensible growing openness to international capital flows. By comparison, this ratio averaged 9.5% in China from 2011 to 2015.

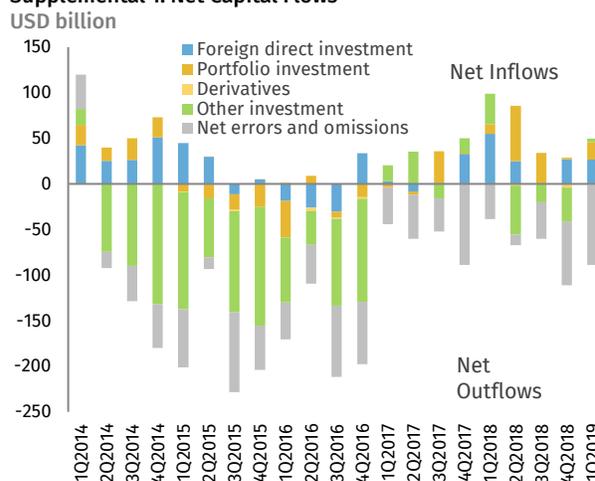
Foreign investment in China’s financial markets appears to be motivated by short-term changes in interest and exchange rates, rather than long-term confidence in the regulatory and investment environment. Foreign portfolio inflows rebounded to \$35.7 billion in 1Q2019 from \$8.1 billion in 4Q2018 (see **Breakdown of Cross-Border Financial Flows**). These inflows were more concentrated in equities than in bonds, responding to an improved economic outlook in 1Q2019. Foreign inflows are poised to surge, but investors remain cautious despite increasing numbers of international equity and bond indices including Chinese assets.

FDI inflows—driven largely by corporations that are less sensitive to financial market conditions—remained at a similar level in 1Q2019 (\$47.6 billion) as in 4Q2018, but Beijing’s efforts to boost foreign investment inflows by abolishing restrictions clearly have not translated into an FDI boom (see **Breakdown of Cross-Border Financial Flows**). The jump in the share of foreign-led mergers and acquisitions (M&A) to 20% in 1Q2019 from 15% in 4Q2018 was mostly a result of a sharp drop in total M&A activity in China (see **Foreign Appetite and Market Access**). As the overall volume of foreign M&A transactions actually dropped, the rise in foreign M&A value in 1Q2019 is not evidence of sustained improvement in China’s receptiveness to foreign acquisitions.

While inflows improved as a result of temporary factors in 1Q2019, capital outflow pressures remain high. Errors and omissions in China’s balance of payments, which reflect capital leaving the country not accounted for

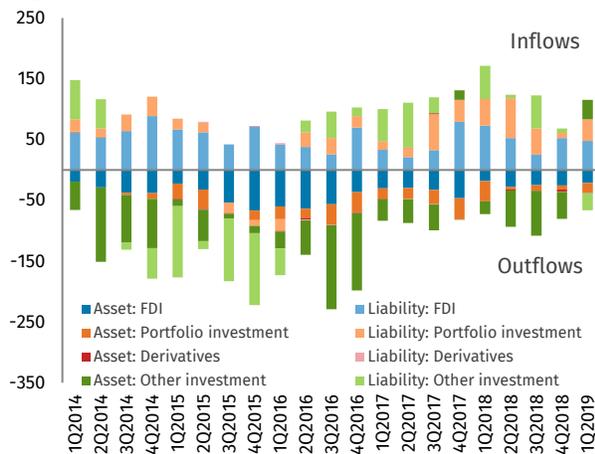
elsewhere, rose to \$87.8 billion in 1Q2019 (see **Net Capital Flows**)—close to the record high for a single quarter. Although China’s currency strengthened modestly during the review period because of global macroeconomic conditions, currency intervention persisted at times—even after official assurances that exchange rates would be liberalized (see **Currency Intervention**). The central bank has continued intervening unilaterally, allowing some appreciation early in 2019 while resisting depreciation pressures through intervention. Even though depreciation is merited as China eases monetary policy, it is an irritant to Washington. Moreover, internationalization of the currency has not progressed: only 1.96% of international financial transactions used the renminbi in 1Q2019—basically unchanged since 2015 (see **Globalization of China’s Currency**).

Supplemental 1: Net Capital Flows



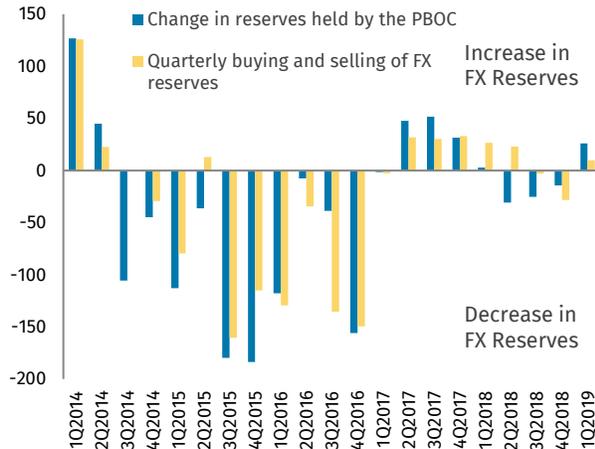
Source: State Administration of Foreign Exchange.

Supplemental 2: Breakdown of Cross-Border Financial Flows
USD billion



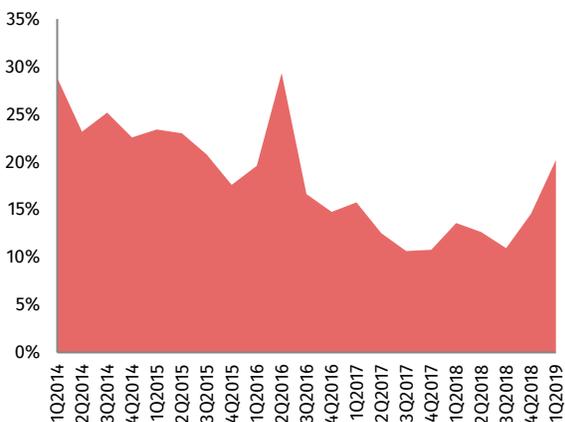
Source: State Administration of Foreign Exchange.

Supplemental 3: Currency Intervention
USD billion



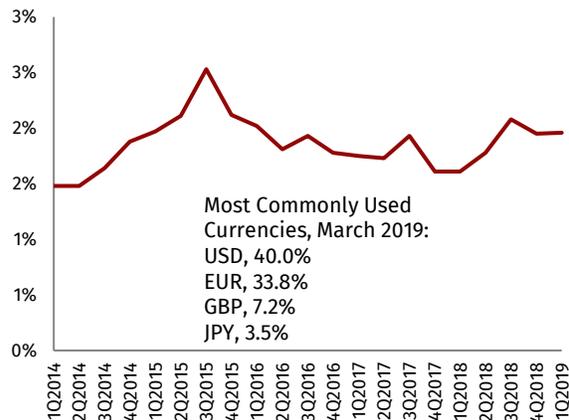
Source: State Administration of Foreign Exchange, Rhodium Group.

Supplemental 4: Foreign Appetite and Market Access
Share of deals with foreign buyers in total number of acquisitions with Chinese target, percentage



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

Supplemental 5: Globalization of China's Currency
Chinese yuan (RMB) usage in global transactions, percent



Source: SWIFT.

Policy Analysis

Official messaging in early 2019 emphasized further liberalization of inbound direct and portfolio investment to balance hardwired capital outflows, but broad structural impediments remain unchanged and new policies add to uncertainty. Restrictions on outbound capital flows are as tight as before, if not tighter.

Following the approval of a new Foreign Investment Law at the annual National People's Congress in March, China advanced a new negative list at the end of June, reducing inbound investment restrictions for additional sectors and shrinking the number of restricted sectors from 48 to 40. Foreign investments in shipping agencies, cinemas, performance agencies, and local gas and heating pipe systems no longer require a controlling domestic partner. Although this change is a step in the right direction, it does not advance opening in critical sectors that could attract significant inbound FDI, such as autos. Restrictions on the service sector continue to limit the scope of future FDI in China. The negative list was received as moderately disappointing in this regard.

Other new policies are problematic for foreign firms, particularly in industries with national security implications. In early June, the National Development and Reform Commission announced plans to establish a "national technological security management list system" to "more effectively forestall and defuse national security risks," although it offered no details. China's Cyberspace Administration released two measures—one on data security and another on exporting personal information—that could have an impact on businesses subject to ongoing follow-up regulations under the Cybersecurity Law. The State Council in June clarified

restrictions on foreign companies’ collection, storage, and sharing of genetic information from China.

Financial sector liberalization to attract foreign investment has been more promising in the past six months, particularly in banking. On May 1, the China Banking and Insurance Regulatory Commission (CBIRC) announced the removal of 20 percent and 25 percent equity limits on investments in individual banks or groups and a \$10 billion asset requirement for foreign-invested banks, as well as the asset requirement to establish branch networks. In the securities business, UBS, JPMorgan, and Nomura were all approved for majority stakes in joint ventures, and Premier Li Keqiang explicitly [vowed to remove](#) all foreign equity restrictions for securities firms by 2020 in July at the World Economic Forum in Dalian. The CBIRC also promised on May 1 that foreign insurance companies will be allowed to invest in already foreign-invested insurance firms, while regulators also removed asset requirements attached to foreign insurance brokerages operating in China. On July 20, it was also announced that foreign ownership caps for insurance companies would be lifted by 2020.

China-issued bonds and equities are gaining more international exposure. On April 1, China government and policy bank bonds were added to the Bloomberg Barclays Global Aggregate Bond Index; after implementation (20 months), Chinese assets will account for around 6% of the global index. Chinese equities were introduced to the MSCI Emerging Markets Index in June 2018 and to the FTSE Russell Emerging Markets index in June 2019. So far, most portfolio inflows into China’s financial markets appear to be more actively managed, meaning they could reverse in response to changing macroeconomic conditions—in contrast to more stable passive flows tracking the performance of major bond indices.

While inflows have become more responsive to temporary conditions than to sustainable, liberalization-driven investor confidence, controls on outbound capital flows remain tight, even if they are not always effective. Former People’s Bank of China advisor Yu Yongding, a longtime proponent of capital controls, even complained publicly that a bank had refused his attempted conversion and transfer of \$20,000 abroad—less than the \$50,000 annual quota for individual foreign exchange transfers. Capital controls have worked when applied narrowly (e.g., to outbound FDI transactions), but the strong volume of errors and omissions—related outflows suggests they remain quite porous even as Beijing attempts to tighten control.

Exchange rate liberalization remains at a crossroads. Political machinations to control the currency discourage inflows since they introduce more uncertainty and fail to follow economic logic. How much exchange rate flexibility Chinese authorities permit—in both directions—will be a key indicator of China’s commitment to cross-border investment policy reform, especially as the trade dispute with the United States intensifies.

Environment

The Story So Far

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

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

Importantly, the law put local governments at the forefront of enforcement, enticing them with 100% of pollution tax revenue.

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

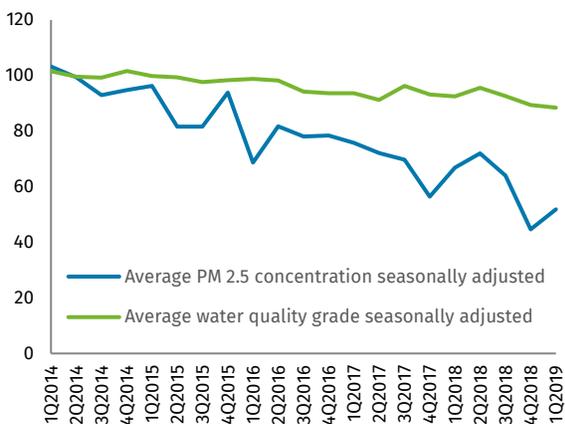
Methodology

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 (PM 2.5) or less, 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 Trends

Index, April 2013 = 100



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

- Our assessment is neutral, a modest downgrade from last quarter. Air pollution in China worsened, and authorities appear to be prioritizing stable economic growth above strict environmental protection enforcement in 2019.
- Water quality continued to improve, but air quality deteriorated as relaxed winter air quality targets and a cyclical rebound in emissions-intensive industries drove up pollution levels.
- The Communist Party of China has signaled it will prioritize economic growth over environmental protection in 2019. After years of stricter enforcement, relaxation may risk environmental backsliding, particularly in air pollution. Officials claim the fight against pollution is still on, although they have abandoned blanket restrictions on high-polluting industries for now.

This Quarter's Numbers

Our primary indicator shows an increase in air pollution in 1Q2019, as rebounding industrial activity pushed up average airborne particulate matter (PM 2.5) levels (see **Environmental Impacts**). Pollution worsened in two regions—the Beijing-Tianjin-Hebei metropolitan area and the Fenwei Plain—targeted for winter pollution reduction. More than three-quarters of the 39 cities in those regions failed to reduce air pollution in line with targets, even though environmental ministry officials set less ambitious targets this winter compared with 2017–2018. Air pollution levels in Guangzhou and Shanghai also rebounded after both cities posted unusually low

numbers in 4Q2018, while Chengdu saw a modest decline.

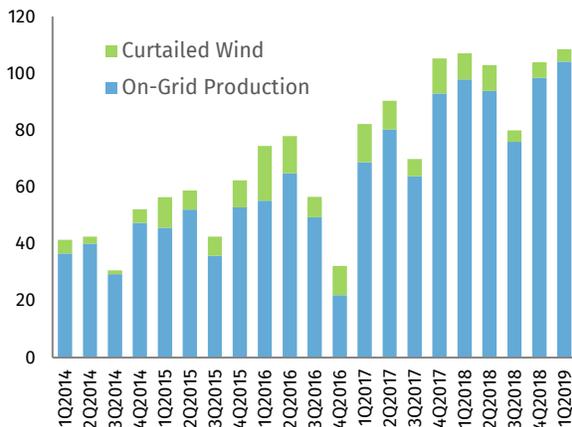
Although air pollution worsened, China sustained water quality improvements, marking three straight quarters of positive progress in our index (see **Environmental Impacts**). Improvement was not uniform across China's river systems, however: the Huang and Songhua Rivers had the greatest improvement in average water quality, while the Pearl and Zhejiang-Fujian systems declined. Conditions in the Yangtze also declined slightly. The "River Chief" system implemented last year, which increases local officials' accountability in protecting local waterways, and an ongoing focus on drinking water sources appear to be having a positive effect on overall water quality, especially in the south.

Our **Wind Energy Curtailment** indicator shows China using wind energy more efficiently. The amount of wind power that was wasted because it could not be transmitted to the electrical grid declined slightly. While power utilities are required under a 2006 law to provide renewable energy with 100% access to the grid, they typically prefer to buy less expensive coal power. A suit by environmental groups to enforce the law in Gansu province went to trial in January, highlighting China's increasing movement to promote clean power.

Sales of New Energy Vehicles (NEVs) increased during the quarter even as overall automobile sales declined. NEV sales have benefited from generous government subsidies to NEV producers, as well as city-specific tax and regulatory incentives, although policy changes are underway, as discussed below.

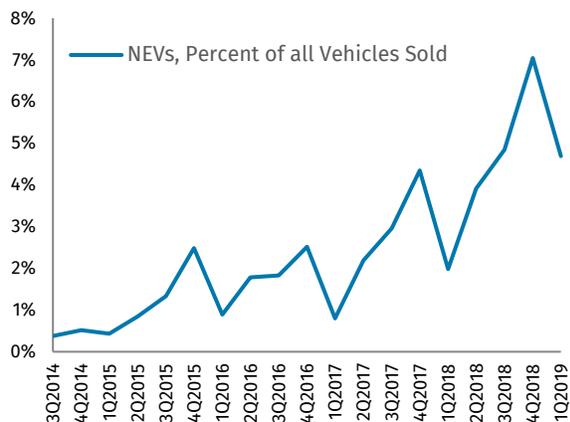
The share of energy from non-fossil fuels declined, but our index—which removes seasonal effects—suggests that this change was not significant compared to last quarter (see **Non-Fossil Generation**). China's use of non-fossil resources including hydropower, solar, and wind continues to grow. However, given growing power demand, overall coal consumption is still increasing even as its share of power generation decreases.

Supplemental 1: Wind Energy Curtailment
Terawatt hours (TWh)



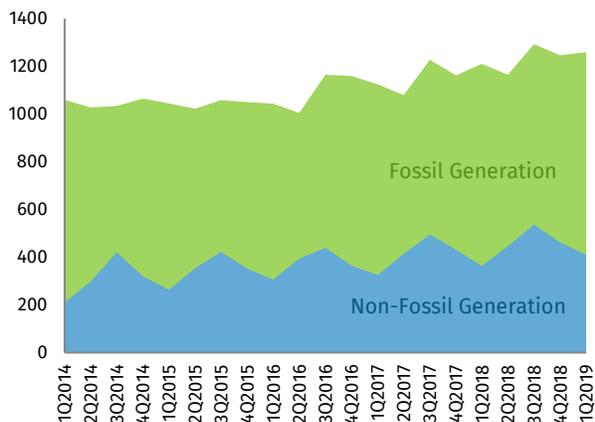
Source: China Electricity Council, Rhodium Group.

Supplemental 2: Sale of New Energy Vehicles
Percent



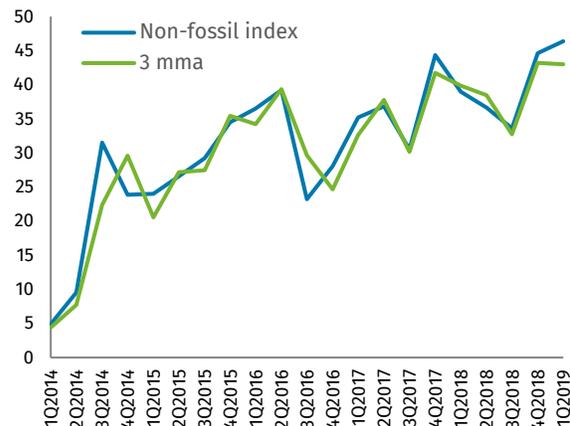
Source: China Association of Automobile Manufacturers, Rhodium Group.

Supplemental 3: Overall Electricity Generation
Billion Kilowatt-Hours



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

Supplemental 4: Non-Fossil Electricity Generation
Index



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

Policy Analysis

Beijing took a relaxed stance on environmental enforcement in 1Q2019 in the face of risks to China’s economic growth. Although policymakers have warned that poor economic conditions do not excuse noncompliance, new policies reflect weaker enforcement and lower pollution reduction targets. This is consistent with the ongoing shift away from rigid, blanket environmental campaigns and overzealous enforcement toward more local and industry-specific approaches. Relaxing policy too much, however, may threaten China’s ability to meet near- and medium-term environmental goals, especially in air quality.

Environmental issues were a major part of Premier Li Keqiang’s annual work report to the National People’s Congress (NPC), a key signal of government policy for the coming year. Premier Li’s comments suggest a more restrained approach to environmental protection enforcement in 2019, particularly in air pollution reduction. For one, he refrained from announcing a specific PM 2.5 pollution reduction target as he did in previous years, even as he declared targets for reducing other pollutants.

Second, Li pledged that the government would prioritize “employment-first” policies in environmental enforcement, including grace periods for environmental compliance and more flexible rule interpretations for small and medium enterprises (SMEs). Officials want to avoid exacerbating the economic slowdown by burdening SMEs with higher compliance costs. However, local officials still face punishment if they fail to meet pollution reduction targets already on the books, even as producers are less incentivized to comply.

Conflicting directives for local officials to deliver on both economic growth and pollution reduction goals likely limit environmental protection progress.

Replacing fossil fuel-powered cars with NEVs creates less air pollution. NEV manufacturers in China have benefited from government producer and consumer subsidies since 2013, keeping prices low and supporting NEV adoption. On March 26, the Ministry of Finance announced it would gradually phase out NEV manufacturer subsidies by 2020 and tighten regulations on how far NEVs can drive before recharging to improve the industry's international competitiveness and drive out inefficient players. In the long term, this move will likely improve NEV quality and help restore market dynamics to a heavily subsidized industry. However, in the near term this policy will prompt industry consolidation, nudging out small and struggling NEV startups by limiting their ability to outsource manufacturing and thus may cause a temporary dip in NEV sales in China.

Lastly, officials responded to yet another disaster in the country's chemical industry. On March 21, a major explosion and subsequent fire at a chemical plant in Xiangshui, Jiangsu, killed 78 people and destroyed several buildings. Although officials (including the State Council) ordered a national assessment of chemical storage and manufacturing facilities, media reports suggest officials acted to suppress data on contamination of nearby water sources and the extent of damage, as local regulators knew the plant was unsafe. Although officials made tentative moves to rein in China's massive chemical and pesticide industries (see **Spring 2019 edition**), the incident shows how far there is to go.

Financial System

The Story So Far

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

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

- Foreign investors' participation in China's financial markets has increased, and Beijing is encouraging foreign portfolio inflows in particular, with the expansion of programs such as the Bond Connect and Hong Kong–Shanghai Stock Connect starting in 2015. In 2018, foreign investors were key marginal investors in China's government bond market and exercised significant influence over China's domestic interest rates. In April 2019, Chinese securities were added to the Bloomberg Barclays Global Aggregate Bond Index, a major benchmark for global bond investors, for the first time.

Methodology

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

Quarterly Assessment and Outlook

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



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

- Our assessment is neutral this quarter, with reform indicators moving in both directions. Our primary indicator shows the financial system becoming less efficient, while efforts to lower systemic risk have reduced murky shadow banking activity.

- Credit growth picked up in 1Q2019 as Beijing eased monetary conditions to stabilize the economy in response to a domestically rooted slowdown and external trade-related uncertainty.
- Marginal financial sector liberalization is occurring even as trade tensions build, with pledges to remove equity caps on foreign investment in securities and insurance. Bank default risks are being priced more efficiently by the market after regulators took over Baoshang Bank (after the review period), but implicit guarantees still impede reform.

This Quarter's Numbers

China's financial efficiency faltered marginally in 1Q2019, with our primary indicator, the **Quarterly Incremental Capital Output Ratio (QuICOR)**, rising to 7.29 from 7.21 in 4Q2018. Capital expenditures are generating less economic output growth, with gross domestic product (GDP) expansion at the slowest pace since the global financial crisis. As gross capital formation has slowed in the last six months, our indicator will improve later this year as long as overall growth stabilizes. Nevertheless, still twice as much capital is required to generate the same output growth in China as in best-practice nations. This is the legacy of high debt levels and implies that politics continue to trump market forces in allocating credit, reducing returns to new investment.

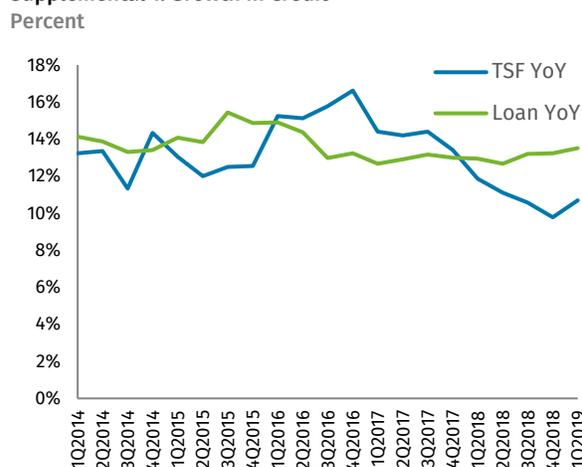
Overall **Growth in Credit** picked up to 10.7% year-on-year in 1Q2019 from 9.8%, as the PBOC added liquidity to the banking system and steered money market rates lower to counteract a slowing economy. This modest rebound in credit growth does not necessarily impede financial reform. After an extreme contraction in shadow financing channels in 2018 under Beijing's deleveraging campaign, some boost in credit growth was to be expected for countercyclical management. Current credit growth in the 9%–10% range is far below the 16.6% growth seen three years ago. Because China's financial system is enormous—with over \$40 trillion in bank assets—it will not likely return to previous growth levels. Even so, the pace of credit growth once again exceeds nominal GDP growth, meaning that China is adding to economy-wide leverage rather than moderating the debt load.

Consistent with the pickup in credit growth, private sector firms enjoyed improved access to financing this quarter. Corporate financing primarily took the form of lower-interest and short-term bill financing loans—often

used for working capital. However, after the difficulties the private sector endured in 2018, it will take more than a few quarters to establish confidence that Beijing is ready to level the playing field for private firms, which are benefiting less than their SOE cousins from easier money.

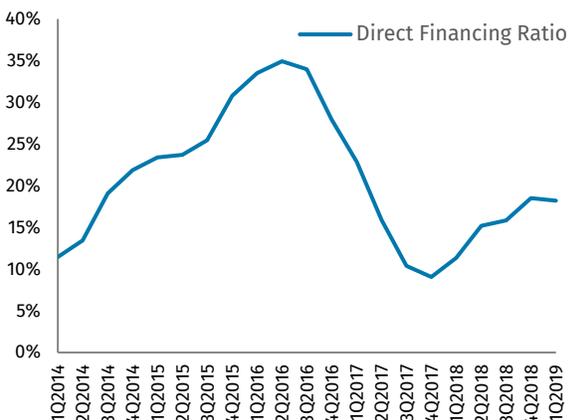
The PBOC eased monetary policy as a countercyclical tool to boost growth, resulting in a significant decline in money market rates during the review period. As a result, shadow banking funding costs have dropped close to the level of banking system funding costs over the past three quarters (see **Interbank Lending Rates**). Offering rates on Yu'e Bao investments, the country's biggest money market fund, which we use as a benchmark in our indicator of financial repression, dropped to 2.53% in 1Q2019, down more than 160 basis points in a year (see **Return on Savings**). This decline indicates that risky shadow banking investments were less attractive relative to more standard products and deposits, which is a positive for financial reform even though it translates into less interest income for depositors.

Supplemental 1: Growth in Credit



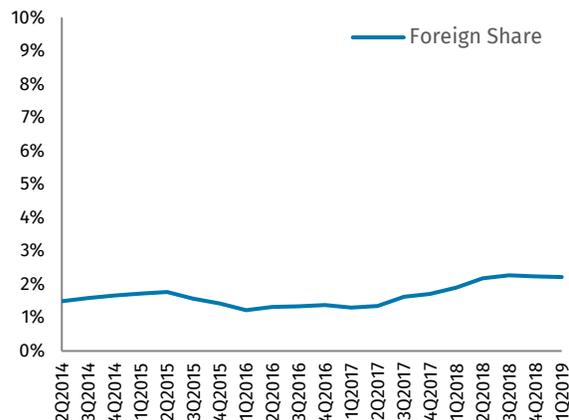
Source: People's Bank of China.

Supplemental 2: Direct Financing Ratio
4qma, percent



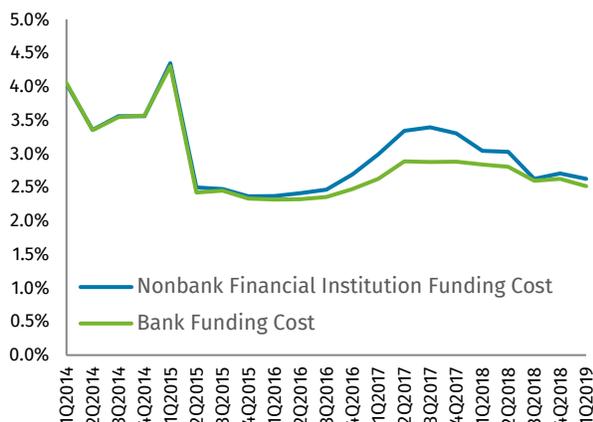
Source: People's Bank of China, China Securities Regulatory Commission.

Supplemental 5: Foreign Held Bonds
Quarterly average, percent



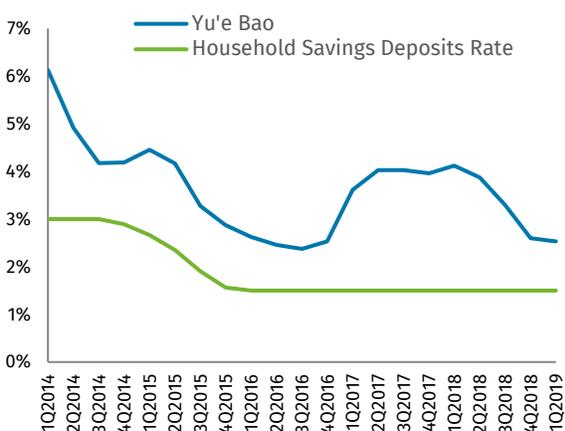
Source: ChinaBond, Shanghai Clearing House, Rhodium Group.

Supplemental 3: Interbank Lending Rates
Quarterly average, percent



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

Supplemental 4: Return on Savings
Quarterly average, percent



Source: People's Bank of China.

Policy Analysis

Better market-driven pricing of credit risks is an essential component of financial reform, by breaking the implicit guarantees that are widespread across China's financial system. The most significant development for financial reform was the sudden takeover of Baoshang Bank, a reasonably large city commercial bank in Inner Mongolia, on May 24. While the exact cause precipitating the takeover remains unclear, regulators' decision to seize the bank signaled that bank defaults on corporate and interbank deposits are now possible. The net result of the first bank default since 1998 has been a market scrambling to price potential risk, with large banks refusing to lend money to smaller banks or nonbank financial institutions in the interbank market, out of fear that they could be the next Baoshang. So far, authorities have restructured two other banks—Bank of Jinzhou and Hengfeng Bank—facing severe funding stress in the fallout from Baoshang's takeover.

New bank default risks are now being priced by the market, which is a positive step. But by providing ad hoc liquidity assistance and guarantees to *other* banks affected by the fallout from Baoshang, regulators undermined the reform signals they had sent. In addition, the resulting rise in funding costs for smaller banks and nonbanks resulting from the injection of counterparty credit risks after Baoshang's default may widen the gap between formal bank and shadow bank financing rates, reopening regulatory arbitrage opportunities.

As financial risk emerges, fuller interest rate liberalization becomes more crucial to the course of reform. Presently, bank funding costs are mostly fixed by

the benchmark deposit rates set by the central bank (as shown in **Return on Savings**). This creates the regulatory arbitrage opportunities that gave rise to shadow banking and other financial risks. Unified funding rates for the banking system allow the central bank to influence credit conditions in the economy more directly through changes in monetary policy, which is closer to a developed market system of managing interest rates. Ultimately, the goal is to see lending rates determined by market forces rather than State Council preferences.

So far, however, deposit rates have not risen in 2019, even as money market rates have fallen sharply. China is expected to announce additional steps toward interest rate liberalization in the second half of 2019, but the scope remains unclear due to bureaucratic conflicts. Eliminating benchmark deposit and lending rates once and for all, or explicitly basing them on a market rate, would represent significant steps forward for market pricing of capital in China's financial system.

The most important policy variable to watch at present is Beijing's appetite for financial sector opening to foreign participation, even as leaders emphasize self-reliance in response to trade tensions. Both Premier Li Keqiang and PBOC Governor Yi Gang have committed to additional brokerage and insurance industry opening to foreign firms without equity caps. Premier Li reiterated these commitments at the Dalian World Economic Forum, proposing a 2020 deadline. Such pledges date at least to 2017, but progress has been limited. JPMorgan and Nomura received approvals to establish majority-owned brokerage joint ventures this year, following earlier approval for UBS, and Allianz won approval for a wholly foreign-owned insurance holding company. However, a myriad of procedural hurdles remain; payments firms Mastercard and Visa still face obstacles even seven years after Beijing promised to abide by a World Trade Organization decision insisting they be allowed to operate.

Fiscal Affairs

The Story So Far

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

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

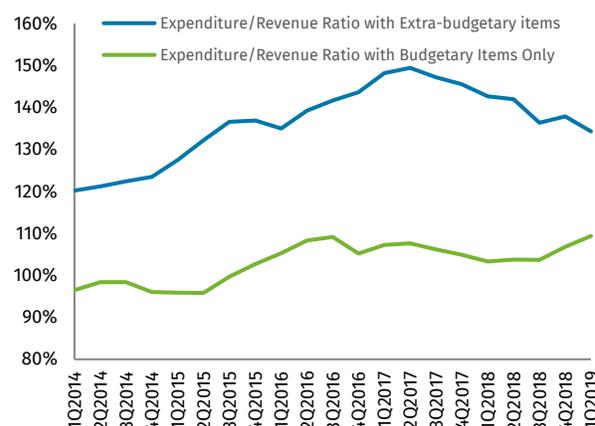
While the exact amount of local government implicit debt is unknown, credible estimates put the actual level at 30–45 trillion RMB (\$4.3–\$6.5 trillion) as of today. Since the heavy debt burden has been crippling for localities, Beijing relaxed guidance on debt repayment in October 2018, allowing local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

Methodology

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

Quarterly Assessment and Outlook

Primary Indicator: Local Governments Expenditure-to-Revenue Ratio
4qma, percent



Source: National Bureau of Statistics, Rhodium Group.

- We modestly upgrade our assessment of fiscal affairs reform: local government spending is still outpacing revenue, but Beijing is reducing this gap while engineering a slow transition of new debt issuance from costlier and riskier off-balance-sheet funding to official, on-balance-sheet funding through bonds.

- Our primary indicator shows that local governments narrowed the augmented fiscal gap in 1Q2019 by boosting their intake with bond issuance, even though they still outspent their budgetary resources.
- Beijing continued tightening policy against local government implicit debt growth, meaning that rising expenditures will increasingly be funded through stronger bond issuance rather than shadow banking channels. Local governments still bear the fiscal burden of delivering Beijing’s infrastructure-led stimulus.

This Quarter’s Numbers

Our primary indicator shows that local governments are relying more on official borrowing channels, although they are still spending beyond their budgetary resources. Our augmented **Local Expenditure-to-Revenue Ratio** improved as a result of unseasonably strong local government bond issuance, falling from 138% in 4Q2018 to 134% in 1Q2019, its lowest level since 3Q2015. Compared with peak levels, the gap between what local governments spend and what they take in is narrowing—a key fiscal affairs reform objective—but expenditure still exceeds even extrabudgetary revenue by 34%, which means that local fiscal practices cannot be described as prudent.

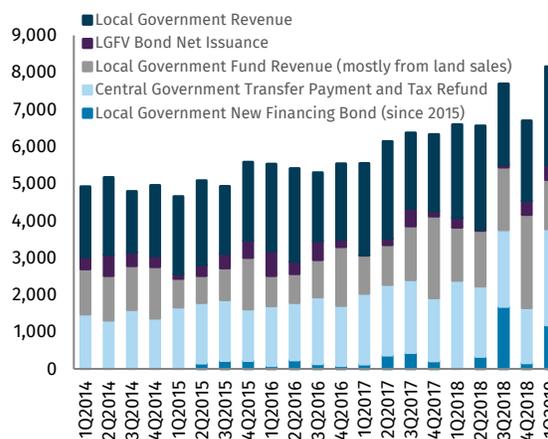
Local bond issuance is typically small in the first quarter, yet it was frontloaded this year to counter economic slowdown. Net special revenue bond issuance reached RMB 1.2 trillion (\$173 billion) in 1Q2019, the second-highest amount on record and more than seven times higher than 4Q2018 issuance (see **Sources of Local Government Financing**).

Local governments continue to spend more than they receive, causing the budgetary expenditure-to-revenue ratio to rise as tax cuts and weaker land sales translated into smaller fiscal intake. Local government fund revenue, mostly from land sales, fell 7% year-on-year in the first quarter, its first drop since 3Q2015—the previous cyclical trough in the property sector—and far below the 23.9% growth seen in 2018. Local governments typically have up to one year to collect developer payments for land purchases, so falling revenue now reflects last year’s property market downturn, which currently shows no signs of recovery.

Weaker revenue also contributed to larger official and augmented **Fiscal Deficits** this quarter. The national augmented deficit ticked up in 1Q2019, from 14.0% to

14.5% of gross domestic product (GDP), while the official fiscal deficit also rose to 5.2% of GDP from 4.2% last quarter. Spending on transportation, urban and rural communities, and science and technology accelerated this quarter. Social spending, however, has not meaningfully changed as a share of total expenditure, and it even ticked downward in 1Q2019 (see **Social Expenditure**).

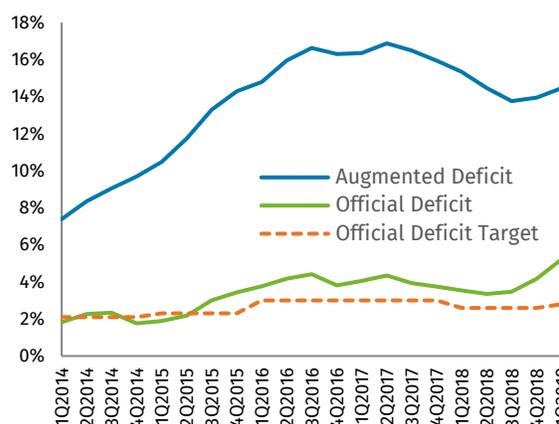
Supplemental 1: Sources of Local Government Financing
Billion RMB



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

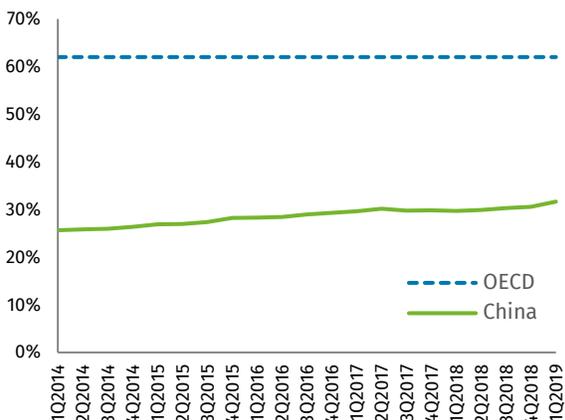
Supplemental 2: Fiscal Deficit Measures

4qma, share of GDP



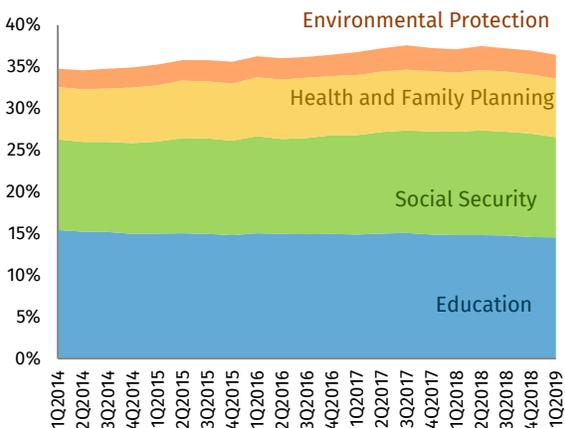
Source: Ministry of Finance, Rhodium Group.

Supplemental 3: Direct Taxation Ratio
4qma, percent



Source: OECD, Ministry of Finance, Rhodium Group.

Supplemental 4: Government Social Expenditures
4qma, percent



Source: Ministry of Finance, Rhodium Group.

Policy Analysis

Improving fiscal health requires more standard and transparent local government financing. Expansion of the local government bond market can promote more responsible local fiscal behavior and is a necessary step in long-term fiscal reform. Over the past six months, stronger local bond issuance bridged the funding gap left by falling land sales revenue. National government fund income—the majority of which comes from land sales—in the first quarter was below the level targeted by the March budget report of the National People’s Congress (NPC), and spending far exceeded targets. Thus, additional local government bond issuance is needed to help fill the growing gap this year. Using transparent funding like bonds is a vast improvement over illicit shadow financing, but ultimately, local fiscal management should be determined less by infrastructure

spending and more by stable income streams like tax revenue.

As Beijing opens the “front door” wider to on-balance-sheet financing, efforts to close the “back door” on shadow financing continue. The central government tightened fiscal measures to control local governments’ implicit debt growth. In May, Beijing banned the use of “engineering, procurement, construction, and financing”—short-term, leveraged funding from contractors—for local government investment projects. Authorities renewed crackdowns on public-private partnerships to eliminate projects that increase local implicit debt burdens. Together, these measures limit local governments’ access to costlier hidden borrowing and redirect future spending toward more affordable, official borrowing channels.

Localities are under more fiscal stress as intake falls and spending pressure rises, particularly in interior and western provinces. In April, the Ministry of Finance published its first-ever fiscal difficulty indicator quantifying fiscal stress at the local level. Qinghai, a western province where a local government financing vehicle defaulted on a bond earlier this year, ranked most troubled, while Beijing faces the least fiscal pressure. At a June NPC meeting, Standing Committee member Li Yuefeng warned that some local governments in western China, most of which rank among the highest in fiscal difficulty, are struggling to cover even basic spending on salaries, social welfare, and government functions.

Transparency is important for improving fiscal efficiency, but more imperative in the long run is narrowing the gap created by Beijing’s limitations on local fiscal autonomy. While local bond issuance is a medium-term solution, Beijing’s mandate to use infrastructure spending as a short-term economic stimulus worsens fiscal pressures on localities, which must carry out high-cost, low-return investments. The National Development and Reform Commission recently allowed local governments to use special revenue bonds as equity for infrastructure projects, suggesting infrastructure-led stimulus remains a priority. Material improvement in local fiscal health likely depends upon less central pressure on local governments to meet growth and investment targets and to deliver infrastructure-led stimulus, which is unlikely before 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 succeeded with limited government policy support. In other cases, innovation interventions have helped, at least for a while.

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

- In March 2018, the U.S. Trade Representative’s Section 301 Report concluded that key parts of China’s technology push, including MC2025, were “unreasonable or discriminatory and burden or restrict U.S. commerce.” The United States then imposed trade tariffs on \$250 billion worth of Chinese imports over the course of 2018, including some products related to MC2025 and many that were not.
- In May 2019, the U.S. Trade Representative raised tariffs from 10% to 25% on nearly \$200 billion of goods from China and started to review tariffs on the remainder of imports from China. Beijing retaliated by raising tariff rates on some imports from the United States. The U.S. Department of Commerce also added several Chinese high-tech manufacturers to its “Entity List”—a list of companies believed to present national security risks to the United States—effectively restricting those firms’ access to U.S. exports.

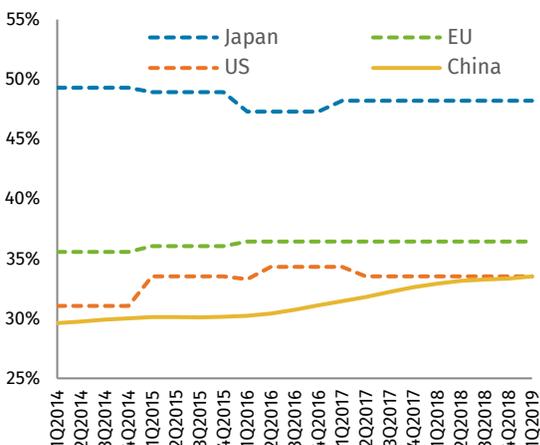
Methodology

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

Quarterly Assessment and Outlook

Primary Indicator: Innovation Industry Share in Industrial Value-added

4qma, percentage



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

- Our assessment of China’s innovation reform progress in 1Q2019 is positive. Innovative industries are playing a more important role in China’s manufacturing sector, as shown by our primary indicator.
- China’s innovative sector outperformed others as overall industrial activity rebounded in 1Q2019. It was boosted by policy support and optimism surrounding trade talks with the United States, which have become a point of concern in light of recent tensions.
- Beijing marginally reduced market entry barriers, improved the intellectual property regime, and expanded capital market access for domestic tech companies, which are positives for innovation, although systemic trends remain troubling to firms and foreign officials.

This Quarter’s Numbers: Parity with the United States Reached

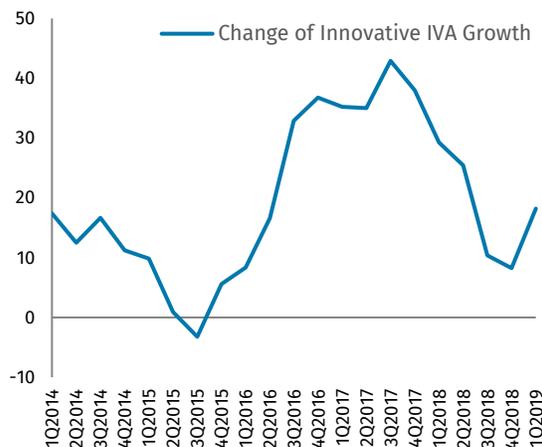
China’s innovative sectors continued to outperform other industrial sectors in early 2019. Our primary indicator, **Innovative Industry Share in Industrial Value-Added (IVA)**, increased for the fourteenth consecutive quarter. As of 1Q2019, China’s innovative manufacturing sectors accounted for 33.5% of total value-added in industrial activities—on par with the U.S. level (33.5% as of 2017) and just below the European Union (36.4% as of 2017). This marks a significant moment in China’s development and helps explain why many advanced economies, including the United States, feel

that China’s policy obligations to peers should be on a par with developed nations, not with developing economies.

Policy measures to counter China’s slowing economy benefited innovative industries. Additional liquidity in the financial system, frontloaded fiscal policy support, tax cuts, and expectations of a trade war truce earlier in the year contributed to rebounding industrial activity in general and innovative activity in particular. Reported IVA growth, at 8.5% year-on-year, was the highest since 2014. Stimulative policies, which were responsible for this uptick, often benefit the traditional industries such as steel and cement more than high-tech industries. Four of the seven industries we use as proxies for innovative activity grew faster than the industrial average this period (see **Industrial Value-Added Growth Rates for Specific Innovative Industries**).

As noted in previous editions, industries with a higher share of foreign ownership have weathered the domestic slowdown better. The communication, computer, and electronics manufacturing sector, where over 70% of companies have received foreign investment (including Hong Kong and Taiwan), saw the strongest IVA growth, though the growth rate has decreased since 4Q2018. The auto sector, where foreign investors are required to form joint ventures with local partners, lags the rest, falling to 4% growth in 1Q2019, its slowest single quarter in our five-year observation window. Conditions in the auto sector are dragging down overall industrial activity because of difficulties with implementing new emissions regulations, overcapacity, and consumer pessimism.

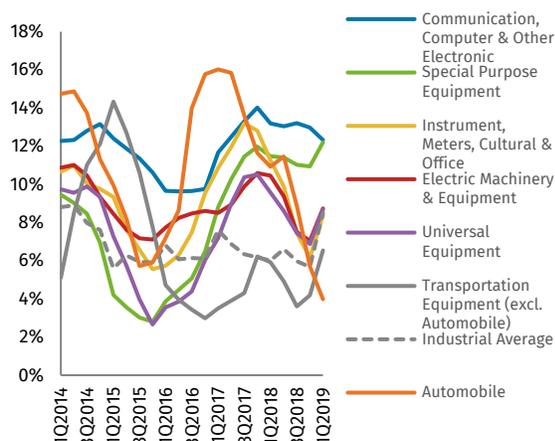
Supplemental 1: Volatility in Innovative Industry 4qma, bp



Source: National Bureau of Statistics, Rhodium Group.

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

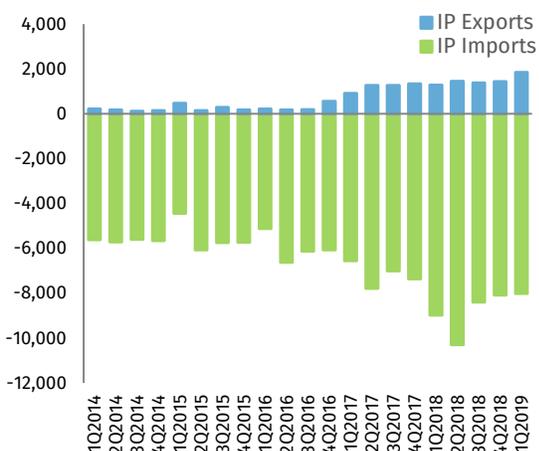
4qma, percent



Source: National Bureau of Statistics, Rhodium Group.

Supplemental 3: Intellectual Property Flows

USD Million



Source: National Bureau of Statistics, Rhodium Group.

Policy Analysis

China’s innovation policies in early 2019 emphasized reducing market entry barriers, improving the legal infrastructure for IPR protection, and providing better capital market access to domestic technology companies. Authorities implemented new measures to address problematic past practices, with some material improvements. Beijing also launched a capital market initiative to sustain funding for innovative companies as the economy cools.

Historically, foreign investment and global value chain participation have been main drivers of industrial upgrading and technology advancement in China; in the current period, Beijing announced new opportunities for

foreign investment (see **Cross-Border Investment**), which will likely support innovation. In July, the Ministry of Commerce updated its “negative list” to reduce the number of restricted sectors for foreign investment from 48 to 40. In addition, the Ministry of Industry and Information Technology rescinded two “white list” regulations in shipbuilding and new energy vehicle battery manufacturing that excluded certain foreign investors from entering the market. While hurdles to implementation remain, these are positive steps toward a more competitive environment in domestic industries, which is conducive to innovation outcomes.

China needs stronger IPR protection to foster and commercialize innovation. Over the past six months, Beijing addressed several problematic policies that undermined IPR protection amid ongoing U.S.-China trade talks, suggesting that these changes were made in response to U.S. complaints. As noted in the **Spring 2019** edition, the State Council in March removed several controversial provisions in the Technology Import and Export Regulation, which were specifically cited in the U.S. Trade Representative’s March 2018 Section 301 Report as proof of China’s discriminatory treatment of foreign IPR. The revisions likely contributed to Washington’s decision on June 3 to suspend a pending World Trade Organization complaint—originally launched in March 2018 in tandem with the Section 301 case—regarding China’s IPR protection regime. Additionally, the National People’s Congress Standing Committee (NPCSC) passed several amendments to the Trademark Law and Anti-Unfair Competition Law in April. These included shifting the burden of proof from the plaintiff to the defendant when evidence of a violation is strong and explicitly outlawing obtaining trade secrets through electronic intrusion. In an unusual move, the NPCSC fast-tracked the process, and the changes became effective immediately. Although these actions addressed some U.S. concerns about forced technology transfer and cyber theft, they did not prevent the trade war from escalating (see **Trade**).

Meanwhile, Beijing launched a major capital market initiative to attract and support domestic technology companies as the long-running boom in private equity and venture capital investment moderates. The Shanghai Stock Exchange Science and Technology Innovation Board (STAR) started trading in late July. One of Beijing’s goals is to give domestic innovators more access to direct financing. Companies that seek to list on the STAR board must only register with the exchange, rather than wait for government approval. Profitability and minimum capital

requirements have also been relaxed for companies that can demonstrate sufficient technology or innovation potential.

Labor

The Story So Far

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

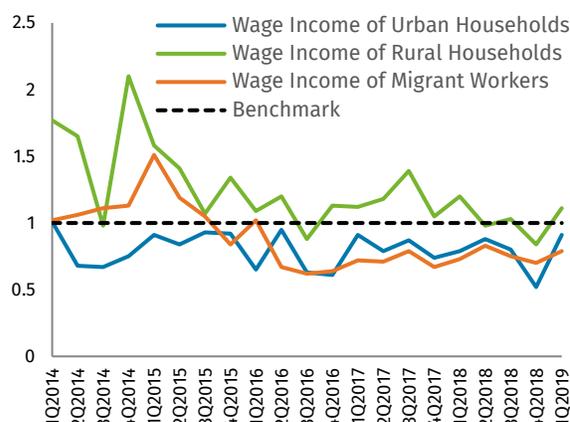
- In July 2014, authorities issued an *Opinion* that called for relaxing the burdensome restraints on individuals who wished to change their residency (the household registration or *hukou* system). This new policy eased controls for those wishing to move to smaller cities while leaving in place more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

Methodology

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

Quarterly Assessment and Outlook

Primary Indicator: Wage Growth Relative to GDP Ratio



Source: National Bureau of Statistics, Rhodium Group.

- We upgrade our assessment based on a modest and likely temporary improvement of migrant and rural worker wage growth and positive policies such as *hukou* relaxation, worker training, and measures to reign in healthcare costs.
- Progress on wages is likely driven by improvement of overall economic conditions and thus is temporary. Employer demand remains mismatched with worker supply, and government social spending and job creation are stagnant.

- Policymakers have yet to address structural impediments in the labor market. Measures to curb healthcare costs are a step in the right direction but still inadequate. Hukou relaxation and reemployment training may help with labor mobility and job matching, but the emphasis on rural revitalization undermines the effectiveness of policies supporting labor mobility.

This Quarter's Numbers

The labor market showed signs of improvement in 1Q2019, largely as a result of better economic conditions rather than structural reform. Lending, investment, and industrial production all slowed at the end of 2018, forcing businesses to cut back on labor costs. In 1Q2019, government stimulus and cheaper credit started to reverse these trends to the benefit of workers. Though wage growth was better than the dismal rate seen in 4Q2018, it still lagged GDP growth, implying that China did not make meaningful progress toward the 2013 Third Plenum goal of lifting the labor share of income. Moreover, the fact that employment remained stagnant even as the economy improved points to enduring problems in matching labor supply with labor demand.

Our indicators show all categories of wages improving in 1Q2019 compared to the previous quarter, but income for most earners continued to grow at a slower pace than GDP (see **Wage Growth**). Our primary indicator, migrant wages, shows that Beijing is failing to encourage labor mobility and create new employment opportunities. Real migrant wage growth remains the weakest of the three demographics we track, increasing from 70% of the rate of GDP growth in 4Q2018 to 79% in 1Q2019. Real urban income growth saw the strongest upturn from the previous quarter, from 52% to 91% of GDP. Rural income performed best this quarter, growing 11% faster than GDP and helping narrow the rural-urban income gap.

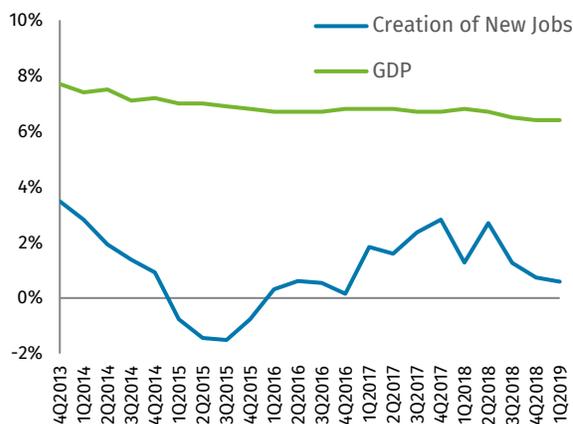
While better economic conditions supported wage growth in 1Q2019, our employment indicators show there are still structural impediments to labor mobility and the development of human capital. **New Job Creation** fell for the third consecutive quarter (well below GDP now, at a mere 0.6% year-on-year (yoy) growth rate). At the same time, available positions continued to outnumber people applying for them, indicating that jobs created in most areas were not aligned with local worker availability (see **Labor Demand-Supply Ratio**). Conditions did improve slightly in Eastern China, where wages and human

capital are higher, but the gap is still historically wide. The *hukou* system is still preventing qualified applicants from relocating to fill new jobs, while local candidates lack the skills that open positions require.

The government is still not spending enough on education, training, and social benefits to address these challenges (see **Social Spending**). Government expenditures improved or were stable as a percentage of GDP in 1Q2019 from 4Q2018. Education spending rose slightly from 3.6% to 3.65% of GDP. However, the three types of spending measured together declined by 0.1% of GDP yoy. This is partly a side effect of the deleveraging campaign to slow expansion of local government and corporate debt, which caused companies to reduce wages and fire employees and reduced local government tax income for social spending. In other words, the squeeze on credit growth pared back government assistance precisely as the need for it grew.

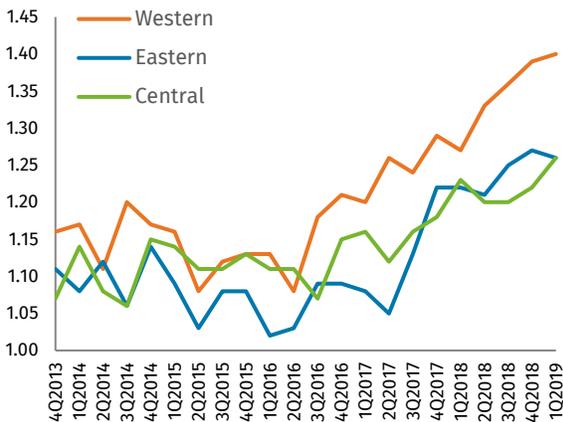
Supplemental 1: New Job Creation

Yoy, percent



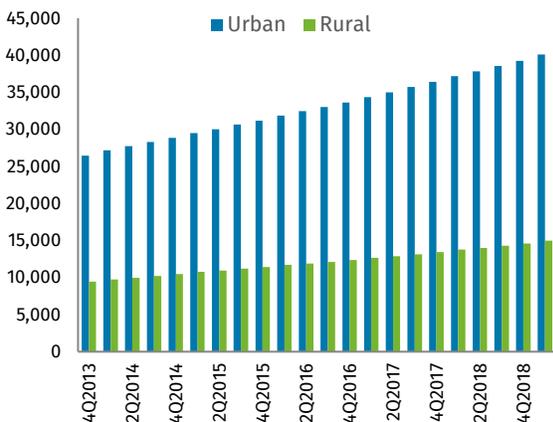
Source: Ministry of Human Resources and Social Security, National Bureau of Statistics.

Supplemental 2: Labor Demand-Supply Ratio
Job openings per applicant



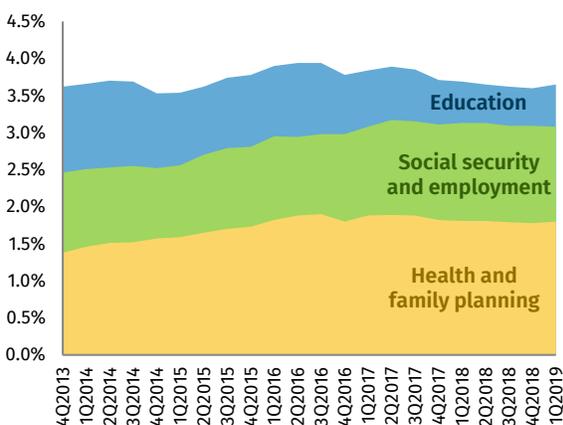
Source: Ministry of Human Resources and Social Security.

Supplemental 3: Rural-Urban Household Income
Annualized RMB



Source: National Bureau of Statistics.

Supplemental 4: Government Social Expenditures
4qma, percent



Source: National Bureau of Statistics, Ministry of Finance.

Policy Analysis

Beijing adopted policies this year to improve labor mobility and education, broaden access to social services, and reduce medical costs. However, without fundamental fiscal reforms and more support from the center, these policies will have only a limited impact on labor productivity and shared welfare. The most important change so far has been an acceleration of reforms to the *hukou* system. On April 8, the National Development and Reform Commission announced plans to relax all *hukou* restrictions in cities with urban populations of 1–3 million this year, and for cities with 3–5 million residents, to ease *hukou* restrictions on migrant workers who have lived in them for more than five years.

On May 5, the State Council followed up with a measure that aims to gradually eliminate all *hukou* restrictions by 2022, except for those in the four mega-cities. Formally, these reforms are meant to channel human and financial capital to and increase social spending in rural areas in line with President Xi Jinping’s “rural revitalization plan,” as discussed in the **Spring 2018 Land** assessment.

In reality, these changes are likely meant to boost flagging demand for property and thus government revenues in smaller cities, which may help social spending in the short term. However, it will be difficult for central authorities to force local governments to grant benefits to migrant citizens, and to the extent that they succeed, it is not clear how localities will afford greater migrant-related expenditures in the long term. The State Council intends to only slightly adjust the ability of localities to manage land resources and generate independent sources of revenue, leaving them poorly prepared to finance the greater spending that Beijing expects of them.

Since *hukou* reform will likely take years to improve the labor market, Beijing has implemented more immediate measures to train workers in specialized fields. On April 30, the State Council decided to set aside 100 billion yuan from the unemployment insurance fund to give 50 million workers vocational training over the next three years, with 15 million workers to be trained in 2019. Furthermore, the Ministry of Education published an action plan in May to admit 1 million more students to vocational colleges.

Authorities are also trying to build on the limited successes over the past year in making healthcare more affordable and accessible. Household spending on healthcare since 2017 has grown on average by 15% yoy,

almost twice as fast as other expenditures. On June 5, the State Council published a 2019 plan for healthcare reforms that aims to reduce the cost of medicines and medical devices, expand the coverage of healthcare insurance, improve the efficiency and quality of public hospitals, and encourage non-governmental investment in the healthcare industry. These policies have worked to some extent – the central government has successfully lowered the cost of basic medicines for urban residents in several major cities. In light of mounting medical costs, however, these limited measures are unlikely to meet planners’ reform ambitions.

Land

The Story So Far

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

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

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

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

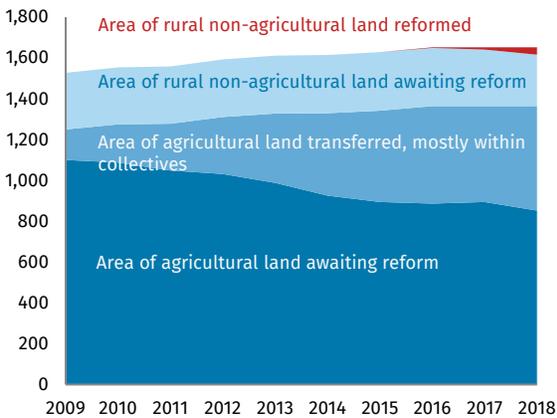
Methodology

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

Quarterly Assessment and Outlook

Primary Indicator: Land Marketized

Million mu (1 mu ≈ 1/6 acre)



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

- Our assessment of land reform is unchanged: rural nonagricultural land reform progress remains nonexistent, though we see mild improvement in land-related economic conditions.
- Authorities did not report new data for our key gauge of nonagricultural rural land reform. Contracting local government land sales revenue this quarter may lead to less resistance to land reform going forward. Rural income growth improved to 10.2% in 1Q2019, but the recovery is likely temporary under the weight of deleveraging.
- Policy developments reinforced rural resident ties to agricultural land, rather than loosening them. These policies may improve agricultural productivity and address food security concerns but contradict the objective of enabling rural households to monetize their land rights to pursue more remunerative opportunities.

This Quarter's Numbers

Land reform in China remains stalled. We define progress as expanding the area of rural nonagricultural land transferred at market prices, but authorities have not published any new data on land transfers this year. Thus, our primary indicator remains the same: only 0.1% of rural nonagricultural land was marketized in the five years since Beijing announced land reforms at the 2013 Third Plenum, while the rest is captive to less productive uses (see **Marketizing Land**).

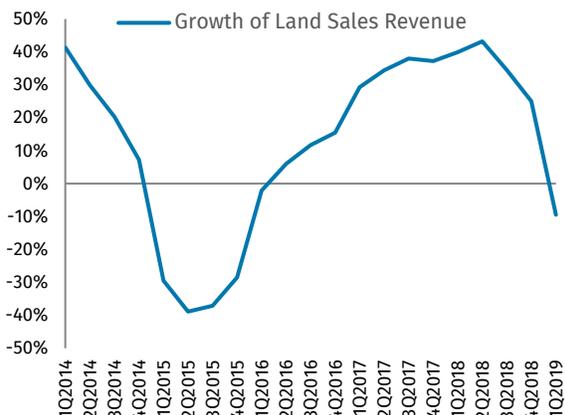
Economic conditions for rural nonagricultural land reform improved slightly this quarter, which is why our overall assessment improved from negative to neutral. One of the biggest systemic hurdles to rural residents transferring their land rights for nonagricultural use is that local governments want to retain their near-monopoly on land sales, enabling them to inflate prices and boost revenue. In 1Q2019, however, local government land sales revenue contracted by 10% year-on-year (yoy) (see **Land Requisition Financials**) compared with double-digit growth in 2017–2018.

Land sales are becoming a less stable source of local government revenue and thus present less of an obstacle to land reform going forward, unless Beijing reverses course on controlling property market speculation to prop up economic growth. The deleveraging campaign squeezed developer funding channels, reducing their ability to buy new land. Policy controls on property speculation remain in place and keep investment demand in check. Demographic changes point to structurally weaker demand for new homes in the medium term. In addition, local government spending on land development exceeded land-related revenue for the first time since 2015, further pressuring local government finances. In sum, these factors reduce local government incentives to rely on inflated land sales for revenue.

Reform of agricultural-use land is moving faster and benefiting rural households, which saw property income growth improve modestly to 10.2% yoy in 1Q2019 from a weaker fourth quarter in 2018. The recovery is consistent with China's economic stabilization in 1Q2019 and with gains from ongoing agricultural land transfer pilots, but it is likely temporary: agricultural lending fell in 1Q2019 (see **Rural Credit**), which will dampen the value of agricultural land and rural income growth in aggregate. Under the current agricultural land reform, rural households can transfer their rights to use agricultural land, but only within their collectives and for agricultural use, tying their land value to agricultural output. Reform progress means making rural economic welfare less dependent on agricultural productivity.

Supplemental 1: Land Requisition Financials

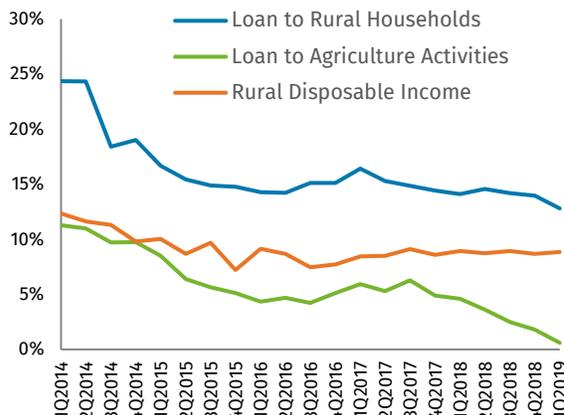
Year-over-year, percent



Source: Ministry of Finance, Rhodium Group.

Supplemental 4: Rural Credit

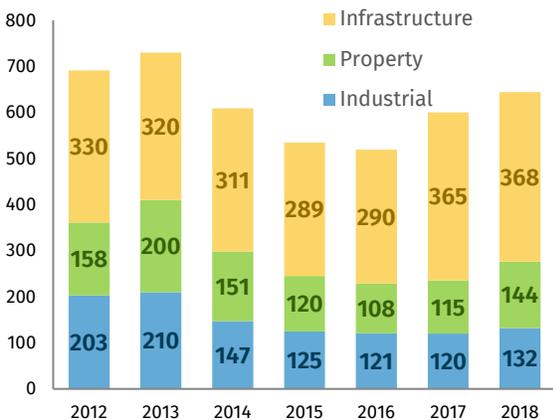
Year-over-year



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

Supplemental 2: Urban Land Supply by Use

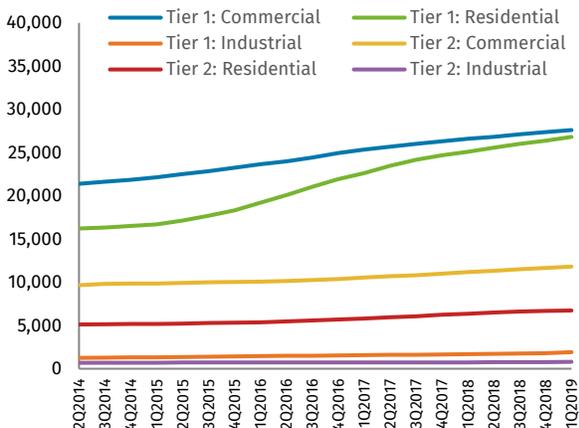
Thousand Ha



Source: Ministry of Natural Resources.

Supplemental 3: Urban Land Prices

RMB per square meter



Source: Ministry of Natural Resources.

Policy Analysis

Though Premier Li Keqiang pledged to accelerate land reform this year at the March National People's Congress (NPC), policy developments over the review period fell short. In May, the Central Commission for Comprehensively Deepening Reform discussed improving the market for transfer, lease, and mortgage of nonagricultural land in a Guiding Opinion and reiterated the goal of unifying the market for urban and rural nonagricultural land transfers. However, the commission named no new measures or timelines to achieve that goal.

Rather than marketizing land transfers to facilitate urbanization, recent policies reinforce rural ties to agricultural land and direct more resources to the rural area. In early May, the Communist Party and the State Council jointly issued an Opinion on removing obstacles such as residential permit rules and different land rights to facilitate integrated urban-rural development. That the Opinion was published jointly by both institutions signifies the highest level of political consideration, but the document itself is not positive for land reform: it insists upon no changes to land ownership, agricultural area designations, or the government's role in planning land use. Instead, it pledges incentives to attract people and capital back toward rural areas and agricultural activities.

Agricultural land reform would improve agricultural productivity. As discussed in our Winter 2018 edition, allowing rural households to exchange their agricultural land use rights with shareholding companies for equity should promote larger-scale farming, boost agricultural productivity, improve labor mobility, and increase rural

household income. MoARA has rapidly expanded this line of effort since 3Q2017, driving property income growth for rural residents. In May, MoARA expanded its agricultural land reform pilot program—which already covers more than one-third of China’s counties—to 12 provinces, 39 cities, and 163 counties. Authorities say the work of transferring land from farmers to shareholding companies in the first 130 pilot counties is complete, and MoARA plans for the remaining pilots to follow suit by October 2020.

Prioritizing agricultural activities could help offset the impacts of the trade war on China’s farming sector but will further diminish rural residents’ ability to transfer agricultural land. At an April press conference, MoARA earmarked 1.1 billion mu of land (180 million acres, or 60% of China’s total agricultural land) for planting “key agricultural products” such as corn and soybeans to address food security concerns—effectively further reducing farmers’ ability to choose how to cultivate their land. Despite improved first quarter economic conditions discussed above, the political environment is less supportive of land 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 that the state would reduce control of commercial SOEs while pushing SOEs in strategic industries to focus on their "core" business areas.

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

improving efficiency. The government also stated that it would strengthen SOE corporate governance but made clear that it viewed Communist Party supervision as critically important.

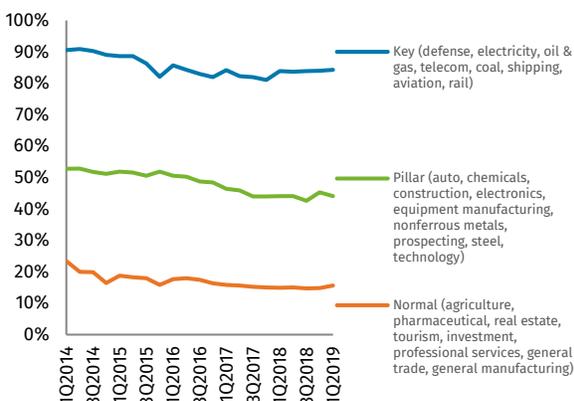
- Since 2017, the government has pushed to "corporatize" SOEs, including establishing boards of directors to replicate the structures of other commercial entities. But it also required all SOEs to institutionalize the role of Communist Party committees into their articles of association and give the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

Methodology

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

Quarterly Assessment and Outlook

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



Source: Bloomberg, Rhodium Group.

- We further downgrade SOE reform progress, as the SOE revenue share in normal industries increased significantly in 1Q2019, meaning that the state has failed to reduce its footprint even in industries with no justification for state presence.
- SOE profitability remains well below that of private firms and is flattening, which suggests that past policies framed as reform have failed to meaningfully improve SOE efficiency.
- The latest policy developments run counter to market-oriented reforms and prioritize Party supervision and control, strengthening existing mechanisms such as central inspections, SOE reporting, and mergers.

This Quarter's numbers

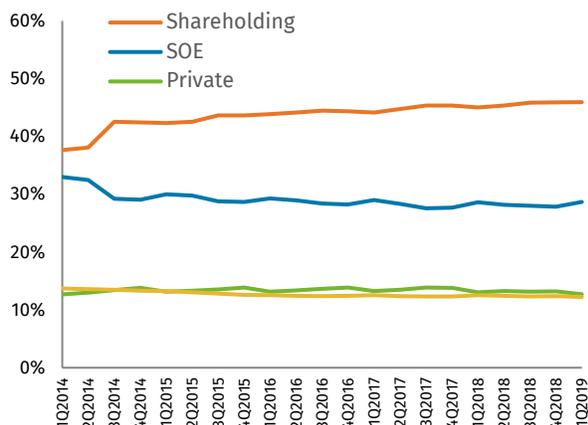
Our primary indicator deteriorated this quarter: the SOE share of listed company revenue in "normal" industries—those that Beijing identified as non-strategic and commercial—increased significantly, to 15.6% in 1Q2019 from 14.8% in 4Q2018. This increase is the first since 1Q2016, and it shows that the state is advancing even in industries where Beijing set out to withdraw influence in the 2013 Third Plenum Decisions (see **The State's Share of the Take**). The increase was driven by faster revenue growth for SOEs than for private firms in the general trade and pharmaceutical industries, both likely related to the U.S.-China trade tensions, which have had the dual effect of exposing private firms to more volatile market conditions and strengthening Beijing's imperative to control critical supplies like drugs.

The SOE shares of revenues in pillar and key industries are more consistent with stated objectives. In key industries that Beijing considers strategic to China's national security and intends to exercise control, the SOE revenue share increased by 0.3% in 1Q2019. In pillar industries where Beijing sees strategic linkages to the country's economic development but is willing to accept a larger market role, the SOE revenue share declined by 1.2% in 1Q2019; however, this decline was slower than that observed in 2016–2017 and insufficient to reverse the uptick in 4Q2018 resulting from state-led stimulus to stabilize the economy. Overall, we see little chance for SOE reform to break through in the next few quarters, as Beijing is more likely to prioritize political and economic stability over reform.

SOEs are also expanding faster than private firms in the industrial sector. SOE assets grew by 4% year-on-year in 1Q2019, faster than private asset growth of 1.4%. As a result, SOEs now hold 28.7% of total industrial assets, up from 27.9% in 4Q2018 (see **Industrial Assets by Ownership**). For now, private firms are still expanding thanks to easier credit conditions. Monetary easing will likely continue in the short term, given continued trade tensions and the emergence of new banking sector risks (see **Financial System**). As these risks play out, credit growth may stabilize and even slow again, constraining private companies' ability to sustain asset growth.

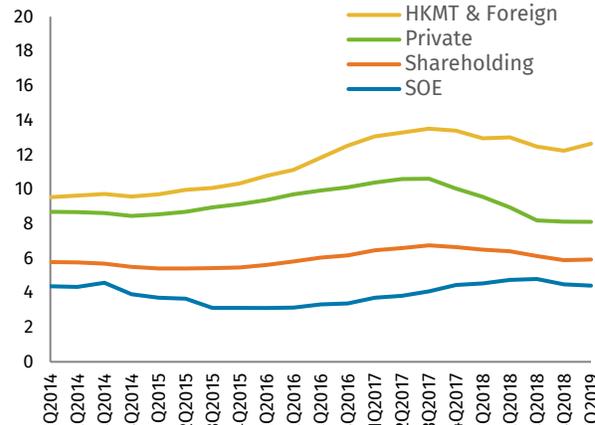
SOE profitability flattened in 1Q2019, suggesting that past policies framed as reform (e.g., capacity cuts, deleveraging) have failed to improve SOE efficiency. Returns on SOE assets peaked at 4.5% in 3Q2018 and then declined to 4.0% in 1Q2019 (see **SOE Return on Assets**). Likewise, SOE interest coverage declined from 4.8% to 4.4% over the same period (see **SOE Interest Coverage Ratio**).

Supplemental 1: Industrial Assets by Ownership
Percent



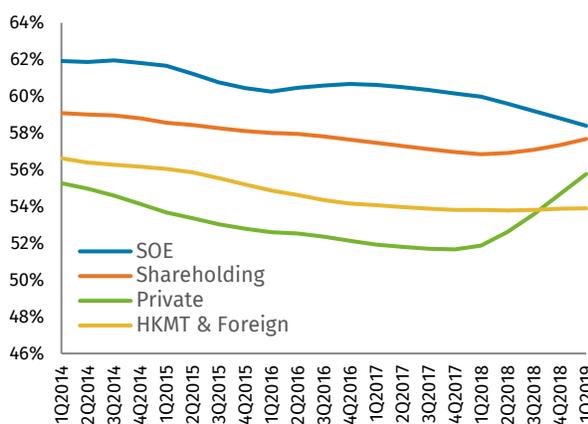
Source: National Bureau of Statistics, Rhodium Group.

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



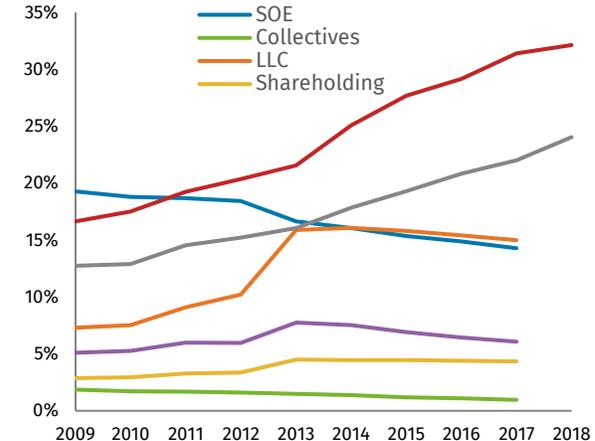
Source: Bloomberg, Rhodium Group.

Supplemental 2: SOE Leverage
12mma, percent



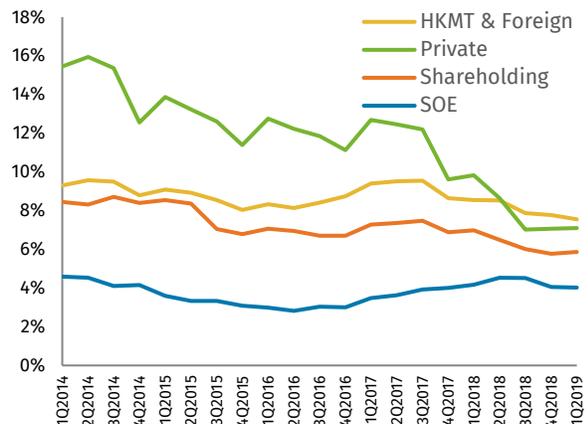
Source: National Bureau of Statistics, Rhodium Group.

Supplemental 5: SOE Share of Employment
Percent



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

Supplemental 3: Return on Assets
Percent



Source: National Bureau of Statistics, Rhodium Group.

Policy Analysis

SOE policies in the review period emphasized stronger Party supervision of market reform, in line with our assessment in the **Winter 2019** edition. Beijing expanded central inspections and SOE reporting coverage, but it has made little progress in granting more decision-making autonomy to normal commercial SOEs, let alone privatizing them.

Central inspections are increasingly used to detect corruption as well as to ensure compliance with policy priorities. On March 29, Beijing dispatched central inspection teams to oversee 42 of 49 core central SOEs, as well as three government agencies: the State-owned Assets Supervision and Administration Commission (SASAC, the owner and regulator of central nonfinancial SOEs); the National Energy Administration; and the State

Administration of Science, Technology and Industry for National Defense. This was the second round of central SOE inspections under President Xi Jinping's leadership and the first-ever inspection of those authorities. According to SASAC head Hao Peng, the goal of the inspections is not only to ensure SOE leader political alignment but also to oversee the implementation of central policies such as capacity cuts, risk prevention, and innovation.

Authorities are taking stock. On May 22, the National People's Congress (NPC) published a Five-Year Plan (2018–2022) for reporting state-owned assets. The plan aims to collect information on financial SOEs in 2018 (completed, see **Winter 2019** edition), administrative assets in 2019, nonfinancial SOEs in 2020, and natural resources in 2021. Like the central inspections, reports will cover SOE policy compliance in addition to financial performance. The plan also requires that provincial and local NPCs establish the same reporting mechanisms and report back to central NPCs by 2020 and 2022, respectively. This system will surely help centralize power; whether it will promote market principles of efficiency at SOEs is unclear.

On April 28, the SASAC announced it would delegate more decision-making authority to SOEs, but it offered no new measures. It reiterated the goals of reducing state intervention and empowering the board of directors, especially for SOEs identified as pilots to manage state capital instead of state assets (see **Fall 2018** edition). Our data indicate that these measures have not meaningfully improved SOE efficiency in the aggregate. In a political environment with increased inspections and reporting requirements, market-based decision-making faces more obstacles than before.

Beijing also continued its recent penchant for brokering central SOE mergers. On July 8, Beijing announced the merger of China Silk Corp. and Poly Group Corp., part of an ongoing effort to merge financially distressed SOEs with more profitable ones in related industries. A week earlier, Beijing announced the merger of China State Shipbuilding Corp. (CSSC) and China Shipbuilding Industry Corp. (CSIC) to strengthen their competitiveness, similar to the merger of China CNR Corp. (CNR) and China South Locomotive & Rolling Stock Corp. (CSR) in December 2014. These arranged marriages run counter to the Third Plenum commitment to delegate more decision-making authority to SOEs. Mergers like these, based on political logic more than market principles and insulated from antitrust reviews,

will impair the competitive environment in China and possibly abroad.

Trade

The Story So Far

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

- Beijing 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. Beijing implemented multiple rounds of import tariff cuts starting in 2015 on a wide range of goods, with a focus on information technology and consumer goods. These tariff cuts reduced the normal, non-discriminatory (“most-favored nation”) simple average tariff to 7.5% in 2018 from more than 9% in 2013 and slightly reduced trade-weighted average tariffs to 4.4% in 2017 from 4.6% in 2013.
- Beijing prioritized “trade facilitation reform” (simplification, harmonization, standardization, and transparency) when it ratified the World Trade Organization (WTO) Trade Facilitation Agreement 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 as a result lower trade-processing delays and costs.
- China’s leaders emphasize the importance of increasing imports to facilitate both internal and

external rebalancing. To stimulate imports and consumption, Beijing tested a series of policies, starting in the Shanghai Free Trade Zone in 2015, to facilitate cross-border e-commerce trade. Key developments include gradually lifting equity caps for foreign e-commerce businesses in free trade zones and passing a new E-commerce Law in 2018, which aimed to reduce the sale of counterfeit goods and services. In January 2019, the State Council increased the scope for tax-free cross-border e-commerce imports across 22 pilot zones.

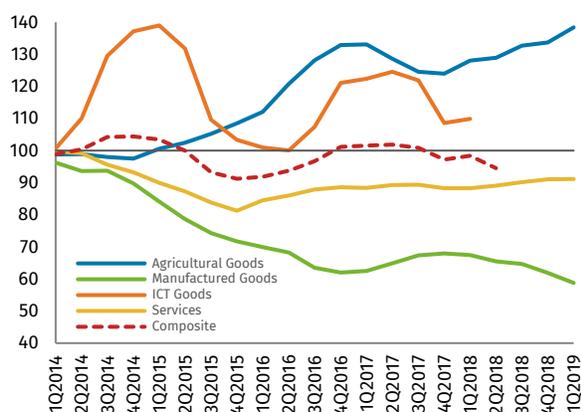
- China has expanded and sought new free trade agreements (FTAs). Since 2002, China has signed 16 FTAs with 24 countries or regions; in 2016, trade with FTA partners (including Taiwan, Hong Kong, and Macao) constituted nearly 40% of China’s total trade volume and saw import duties reduced by RMB 42.2 billion (\$6 billion) that year. Most recently, China signed FTAs with Georgia in May 2017 and with Maldives in December 2017. Beijing is currently negotiating seven other FTAs.

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

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 downgrade trade policy reform slightly this quarter, as our indicators show imbalances getting worse and import openness stalling.
- Our primary indicator cannot be updated because of missing data; its components show no net improvement. Rebalancing trade and moving up the value chain are taking a back seat as tariffs bite, while data suggest less openness to imports and more overcapacity shipped abroad.
- The domestic trade policy landscape remains basically unchanged this quarter. Trade talks offer Beijing the opportunity to liberalize more decisively but policymakers are more likely to focus on near-term offsets to the pain from tariffs and uncertainty rather than responding with reform.

This Quarter's Numbers

For the fourth consecutive quarter, our quantitative analysis of China's trade policy has been hindered by missing goods trade data, which officials attribute to technical problems with a vendor company. As a result, our primary indicator, the Composite Trade Liberalization Index (CTLI), remains incomplete.

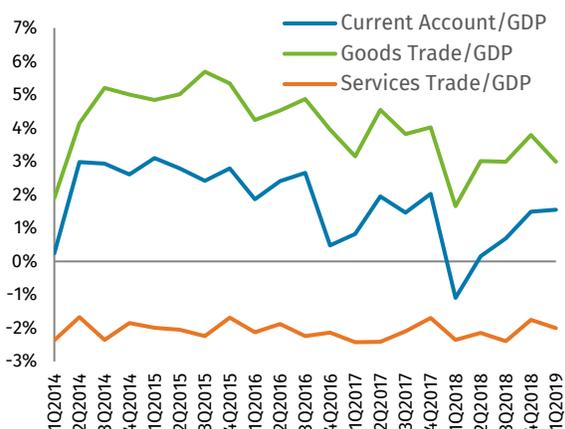
Available CTLI data show no net improvement in trade opening. China's Customs Administration partially updated missing data on nonsensitive but highly protected manufacturing imports in our sample, which have fallen significantly since 2013. Imports of protected agricultural goods increased in 1Q2019, but services imports remained at the same level relative to GDP as the

previous quarter and still below 2013 levels. China's nontourism services deficit shrank because of smaller payments for royalties and transport services, and a stronger surplus in commercial services (see Services Trade Openness).

Reducing persistent external imbalances means relying more on domestic demand for economic growth. China's current account surplus has receded significantly from its 2007 peak of 10% relative to GDP, reflecting some rebalancing of the economy. But the narrowing of the balance from its near-term high of 2.8% of GDP in 2015 to 0.4% in 2018 was driven by expansion of China's services trade deficit and higher import prices, with less evidence of economic rebalancing showing up in trade flows. In 1Q2019, reduction of China's current account paused, with new tariff distortions playing a role. China's first quarter balance rose to \$49 billion, the highest same-period level since 2015 and a sharp reversal from last year's deficit (see External Trade). The elevated current account balance was driven by merchandise trade: our economic models and the observed trend both show that the consequences of trade wars for China so far are falling exports accompanied by even faster-falling imports.

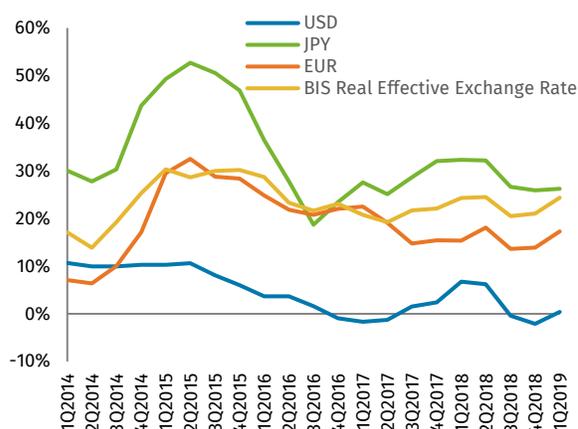
Our Structural Change in Goods Trade indicator shows that more of China's imports were for domestic consumption rather than processing for reexport in 1Q2019. This is positive; however, it is a result of trade squabbles rather than an organic transition to domestic consumption. Export weakness is attributable to declining processing trade exports to advanced markets including the United States, and as a result processing imports fell throughout the first quarter. Net exports of many overcapacity goods—aluminum products, fertilizer, and steel products—increased in 1Q2019 (see Trade and Overcapacity). Localities have loosened air quality and production curb enforcement to prop up production growth as the domestic economy slows (see Environment). Beijing announced localities will dictate output restrictions again this coming winter, meaning China's beggar-thy-neighbor policies will likely worsen industrial overcapacity spillover abroad.

Supplemental 1: External Trade
Percent



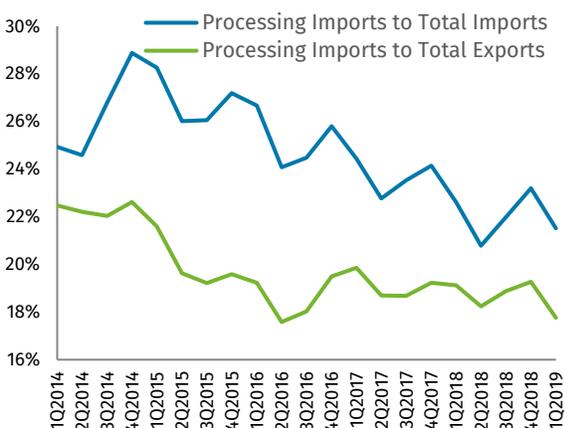
Source: State Administration for Foreign Exchange.

Supplemental 4: Exchange Rate Fluctuation
Percent



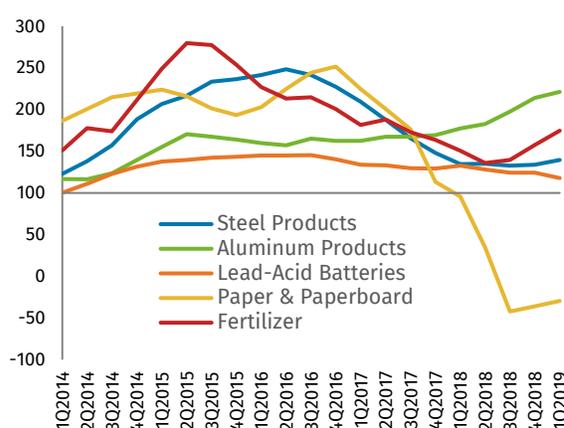
Source: People's Bank of China, National Bureau of Statistics.

Supplemental 2: Structural Change in Goods Trade
Percent



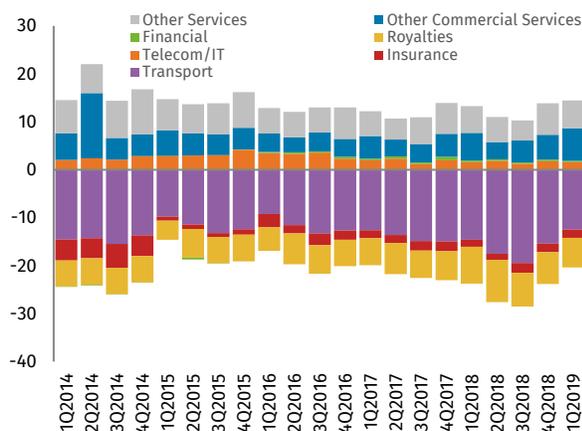
Source: General Administration of Customs.

Supplemental 5: Trade and Overcapacity
Index, 2012=100



Source: General Administration of Customs, Rhodium Group.

Supplemental 3: Services Trade Openness
USD Billion



Source: State Administration of Foreign Exchange.

Policy Analysis

China's trade policy agenda this year has been equal parts piecemeal reform and brinksmanship with Washington. As detailed in our **Winter 2019** edition, in the first quarter, Chinese policymakers reduced import tariffs to support consumers, facilitate industrial upgrading, and offset trade war impacts. But changes in broader trade reforms have not struck other Organisation for Economic Co-operation and Development nations as decisive, and the situation with the United States has gone from bad to worse. U.S.-China trade talks broke down in May, with the United States accusing China of renegeing on earlier commitments. As a result, the Trump administration raised tariffs on \$200 billion in imports from China from 10% to 25%; Beijing responded by increasing tariffs on \$60 billion in U.S. imports. A June State Council white paper on bilateral trade tensions blamed the United States for the breakdown and

reiterated Beijing’s three “red lines”: that any trade deal requires Washington to remove all tariffs imposed since Trump took office; that U.S. expectations for purchases of U.S. goods be “realistic”; and that the agreement maintain a “proper balance” of commitments on both sides.

At the Trump–Xi Jinping bilateral meeting at the G20 summit in Osaka in June, the two leaders agreed to resume talks and President Trump agreed to delay raising tariffs on the remainder of imports from China while talks proceeded. For a time, China resumed occasional purchases of U.S. agricultural goods (sorghum, soybeans, and rice), suggesting that talks were back on track. But the post-G20 reprieve proved short-lived, and bilateral trade tensions now appear locked in a downward spiral. After a round of talks in Shanghai considered constructive by both sides, on August 1, President Trump tweeted that the United States would raise additional 10% duties on the remainder of imports from China not already subject to tariffs by 10% (around \$267 billion) starting on September 1 because Beijing failed to deliver on promised U.S. agriculture purchases and crackdown on fentanyl sales. The U.S. Trade Representative later clarified that the new tariffs would proceed in two waves, on September 1 and December 15, to delay the impact on American consumers.

In reaction, the People’s Bank of China (PBOC) allowed the renminbi to fall through the 7.0 per U.S. dollar level, pointing to market forces produced by tariffs as driving the sudden depreciation. Market pressures were already pushing the currency weaker, but the change in the PBOC’s pattern of intervention to give into some of those pressures signals Beijing’s resignation that trade negotiations with the United States were not likely to produce any meaningful de-escalation or reduction in tariffs. The U.S. Department of Treasury labeled China a currency manipulator for the first time since 1994—a designation lacking economic rationale, but it may allow Washington to levy additional duties on imports under a U.S. Department of Commerce rule proposed in May providing trade protection against subsidization from currency undervaluation.

Beijing officially responded to the August 1 U.S. tariff increases on August 23 with two lists of proposed retaliatory tariffs on U.S. imports worth \$75 billion. Calling Beijing’s retaliation “politically motivated,” President Trump immediately vowed to increase the existing 25% tariffs on \$250 billion of imports from China to 30% on October 1 and to raise the September 1 tariff rate from 10% to 15%.

Trade tensions extend beyond tariffs. In May, the Commerce Department added Chinese telecom leader Huawei to its “Entity List”—a compendium of companies considered a threat U.S. national security—effectively restricting its access to key U.S. purchases. In response, China’s Ministry of Commerce announced plans to release its own “Unreliable Entity List.” On August 19, the Commerce Department extended temporary authorizations for some U.S. transactions with Huawei but also added nearly 50 more Huawei affiliates to the Entity List, further setting back the resumption of any substantive trade negotiations. These developments are part of a broader decoupling trend, which will risk further trade, investment, and technology balkanization if not mitigated.