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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.
Fall 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

Anticipation is building once again toward a U.S.-China trade agreement that would pause tariff escalation or even partially reverse it, and potentially include a range of commitments covering agricultural purchases, market access, currency, and intellectual property protections. Simultaneously, there are signs of emphasis from Beijing on reform policy, showing some willingness to engage on sensitive policy issues where reforms have been largely stalled for some time. Should reform fanfare amid ongoing trade negotiations be considered a harbinger of change or just more of the same?

We were early to observe that U.S.-China relations as we knew them were changing fundamentally. We did not think it did any good to pretend that we were just going through a rough patch: engagement had been justified and sustained by signs of China’s policy convergence with market economy norms. The critical mass of evidence that this was still the case had eroded, and without that divergence was inevitable.

Trade tensions are weighing on China’s economy, but headwinds are blowing more from the consequences of domestic policy imprudence in the name of growth, which now contribute to faltering performance and future challenges. The silver lining of near-term pessimism about the costs of U.S.-China tensions and a broader U.S.-China decoupling is that these conditions may hasten a change in course for Beijing, resulting in bolder reforms. Indeed, some U.S. policymakers are hoping for this narrative playing out.

With its tradition of reform over the past 40 years, Beijing is more likely than not to ultimately accept the necessity of reverting back to marketization. However, the current holdup is that a significant degree of political reform must be part of the mix, if the economic reforms are going to be meaningful. Given the malaise that has settled over expectations for U.S.-China relations in the Trump-Xi era, this makes us cautious optimists, but with a difficult course to run. The current bout of Chinese statism is precipitating internal economic trouble, and that will recycle reforms to the fore, re-opening the door to engagement. But when?

Some developments getting attention might qualify as “green shoots” of renewed reform efforts even if the aggregate picture is murky:

- The “double-hundred actions” campaign, launched in August 2018, has focused on implementing mixed ownership and corporate governance reform in more than 400 central and local pilot state-owned enterprises (SOEs) by 2020. If faithfully implemented, this campaign would signal intent to reduce state control in pilot firms and discipline state influence over their commercial decisions.

- In a September joint report with the World Bank, the State Council’s Development Research Center acknowledged pervasive market distortions as a result of existing industrial policies and recommended market-oriented reforms, based on workshops across multiple key government agencies suggesting broad endorsement of the report’s findings.

- Regulators announced concrete 2020 timetables for lifting foreign equity caps on futures, securities, insurance, and banking companies. Alongside this we see a revised foreign insurance company regulation and a new foreign bank regulation that relax operating restrictions.
Following the new Foreign Investment Law’s passage in March (effective in January) and a reduction of entries on the negative list for foreign investment, authorities scrapped quotas on certain inbound foreign investments and committed to lifting foreign equity caps in additional sectors. New implementing measures for the law are now being put to the test.

An October State Council issuance pledges to ensure “all types of business entities have equal access” to key inputs including credit, land, and licenses and “enjoy state support policies equally.” The rule stipulates that no level of government should “force foreign investors and companies to transfer technology, explicitly or implicitly.”

Officials repeatedly echoed commitments to improve the environment for foreign investors and lift the quality of economic growth. These commitments are not new, concrete, or inherently credible, but they have become more frequent in 2019 amid ongoing trade talks and rising risks to the domestic economy.

Premier Li Keqiang held a televised meeting with U.S. executives confirming the direction of China’s reform policies regarding foreign investors and has reiterated in State Council meetings that China will continue to open up to foreign investment, promote ease of investing, protect foreign investor interests, and strengthen investment promotion on the local level.

Central bank governor Yi Gang commented that China should “cherish the scope of normal monetary policy” while other global central banks were easing to cement its position as “the highlight of the global economy and one the market should admire,” suggesting restraint in stimulating the slowing economy to attract capital inflows.

Vice Commerce Minister Wang Shouwen said in October that China will eliminate foreign investment restrictions in financial services and many other sectors, and that China would “neither explicitly nor implicitly” force foreign entities to transfer technologies to Chinese firms.

Former finance minister Lou Jiwei acknowledged the need for China to have more “mature” market rules in financial opening and that “to attract mature institutional investors from overseas, we first need to improve on supervision methods, rules, and procedures.” The Party’s Fourth Plenum, held in November, recognized the 2013 economic reform program as a milestone on par with the historic 1978 Third Plenum and committed to improvement on a number of competition-related issues including the foreign investment negative list, market entry, competition policy, anti-monopoly review, and intellectual property (IP) and business secret protections. However, the Party failed to acknowledge shortcomings in reform implementation since 2013 and unapologetically insisted that SOEs will not retreat from the economy, suggesting a conservative stance going forward on SOE reform.

From day one, our Dashboard indicators were designed to test these commitments. In the main, we find reform in five of ten policy areas has regressed since the 2013 Third Plenum, two areas are stalled, and three areas have improved slightly. In the aggregate neither the outcomes we see at present nor the specifics of the green shoots described above are proof of a change of season – yet. However, actions that would start to bend our indicators in the right direction may be within reach, and the tone and frankness of many policy signals are helpful. If the countervailing indications that are just as readily found – some of them tit-for-tat in response to American moves, some of them, like further enshrinement of the role of Party committees in corporate management, more structural reforms – can be pruned from the policy tree, then the prognosis for China’s engagement with the advanced market economies will brighten.

Dashboard Indicators

Policymakers made much to do about State-Owned Enterprise (SOE) reform achievements in 2019, but our indicators show policies since 2013 have not reduced state control of SOEs or their role in the economy. According to the SOE Reform Small Leading Group (SLG), one-quarter of pilot SOEs have diversified their holding structure, one-third have attracted private capital into group companies, and more than half have attracted private
capital into their subsidiaries. Together, pilot SOEs have completed around 30% of reform tasks and attracted 538 billion yuan ($77 billion) in private capital.

This seemingly positive progress is inconsistent with our primary indicator: the campaign included 61 listed companies, but our indicator picked up ownership changes only in a few SOEs, with no meaningful change in SOE presence in the economy. One explanation is that the pilots did not sell large enough stakes, keeping the state as controlling shareholder. If that is the case, the campaign is not successfully reducing state control over pilot enterprises but rather bringing more private capital under state control.

Efforts so far to professionalize SOE boards are likely inadequate to bind SOEs to market principles as they fail to address one fundamental problem: SOE leaders are still government officials subject to state evaluation; therefore, they are likely to prioritize political objectives over commercial ones compared with private firm leaders. Meanwhile, SOE megamergers are proceeding unchecked, as demonstrated by the late October approvals for combining China’s two shipbuilding giants.

Market opening saw the most policy attention so far in 2019, yet our indicator of Cross-border Investment reform suggests backsliding. Cross-border capital flows continued declining as a proportion of China’s economy in 2Q2019, reaching a record low level of 4.26% of GDP. Both inflows and outflows trended lower relative to the size of the economy this quarter, highlighting the limits to implementing liberalization promises so far, and the urgency of doing so. The growing political divide between China and the rest of the world may become a significant influence on those flows over time, particularly if market-driven investors start to see negative political costs attached to both direct investments in China and portfolio investments in Chinese securities.

In other areas, Beijing has advanced reforms that contributed to slowing economic growth in the short term, causing declines in some indicators.

In Financial System reform, for example, the allowance of bank failure by regulators in May, forcing some depositors to take losses, marks a new era. In addition, incremental steps are being taken to advance interest rate reform, which should unify market and policy rates so that borrowers and lenders respond to more market-based price signals. However, despite these credible and positive intentions, our quarterly incremental capital output ratio reached its highest level this quarter since at least 2011, indicating deteriorating efficiency within China’s financial system. China’s slowing growth, not a resurgence in capital growth, drove the Quarterly Incremental Capital Output Ratio’s rise: in the first half of 2019, capital formation accounted for its smallest-ever share of real economic growth.

The slowing economy is also affecting China’s households, which face not only fewer employment opportunities and lower income growth but also higher costs of living related to healthcare, food prices, and housing, as well as tariff hikes. Wages for urban and migrant workers fell compared to total economic growth, with migrant wages growing 33% slower than GDP. New job creation registered the biggest decline since mid-2015, with 220,000 fewer net jobs created over the past four quarters than in the previous year. Companies appear hesitant to add to payroll amid the current slowdown and future uncertainties. So far this year, Beijing has sought to boost income growth by cutting taxes and increasing lending to smaller, private companies so that they increase employment and wages, but these indirect measures have had little identifiable impact and have only chipped away at the national tax base.

We found slight improvement in Competition policy reform, though our net assessment is still negative. The government reviewed 32 foreign-involved mergers in 2Q2019, fewer than domestic mergers (33) for the first quarter on record. The proportion of foreign-involved mergers reviewed in the second quarter (23%) also decreased from 27% in 1Q2019, even though foreign-involved mergers are still reviewed three times more often than the 8% of domestic mergers reviewed. Chinese courts also published many more competition-related cases this quarter, increasing the proportion of cases published from 5% of total cases handled by the courts in 1Q2019 to 15% in 2Q2019—though they simultaneously removed hundreds of other court cases.

View from Abroad

What concrete moves on Beijing’s part would demonstrate more definitively that reform was again a driving force? There are many candidates. A meaningful set of state enterprises not in truly essential public good industries could be privatized, both to pay down subnational government debt and to promote the centrality of the private sector. Rather than rolling up already large state oligopolies into even larger national champions, regulators could embrace pro-competitive policies to break up or prevent mergers by major domestic firms. Beyond the piecemeal opening to foreign investment, antiquated joint venturing requirements could be eliminated wholesale on an expedited schedule. Beijing could formally and publicly classify SOEs into commercial and noncommercial categories, as envisioned in President Xi’s 2015 Guiding
Opinions, and to allow commercial firms to compete fairly with other market players.

These acid tests of systemic reforms could underpin a sustainable warming trend toward China in economic circles abroad. By contrast, politically conceived target campaigns for growing Chinese imports by a certain percentage by a certain year are more likely – both because they suit the state-planning mind-set prominent in Beijing today and because they are the managed trade approach at the heart of key Washington trade demands of China. A handful of American constituencies – mostly commodity agricultural producers and fossil fuel exporters – could be bolstered by this focus, though they were just as well or better served by market trends that predated the trade war. Other U.S. industries will not benefit from this approach, while most other market economies will view these commitments as opposing World Trade Organization principles and diverting business from their companies. A “Phase 2” of a U.S.-China agreement would focus on structural reform issues like forced technology transfer and industrial subsidies though political flashpoints such as escalating Hong Kong protests may diminish the probability of concluding either phase this year.

As the prospect of truce in the U.S.-China standoff as we have known it in the Trump years looms, this difference in essence – structural move to market orientation or just a package to reduce the U.S. trade deficit no matter how we get there or some combination – will determine the tone of the foreign conversation for the coming months. There are green shoots in multilateral alignment among like-minded market economies on how to respond to shared concerns about the impact of China’s system worldwide as well. On investment screening, export controls, critical infrastructure resilience, data protection, and other fronts, there are some meaningful moves toward commonality among the United States, Europe, Japan, and other developed economies. But whether this basic shared interest can flourish and grow into a true constructive coalition or rather wither under the weight of differences on ambition and continued unilateralism is being put to the test.
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

![Graph showing percentage of foreign-involved and domestic mergers reviewed over time.]

Source: Ministry of Commerce, Bloomberg, Rhodium Group.

- Reform progressed – a little: Beijing reviewed more domestic mergers than foreign-involved mergers for the first time. However, this reflected a falling number of foreign-involved mergers rather than a change in policy.
• For domestic companies, new business registration and pricing power improved slightly this quarter, likely because of more closures by inefficient firms in recent years.

• The government promised to improve China’s business environment and treat all market entities equally during the resumed trade talks with the United States. How well this will be implemented remains a question.

This Quarter’s Numbers

Our competition policy reform indicator suggests slight progress: in 2Q2019, the government reviewed 32 foreign-involved mergers, fewer than domestic mergers (33) for the first quarter on record (see Merger Reviews). Proportionally, 23% of foreign-involved mergers were reviewed, down from 27% in 1Q2019. However, foreign-involved mergers are still reviewed three times more often than the 8% of domestic mergers reviewed. Moreover, no domestic mergers have ever been restricted, while 14 foreign-involved mergers have been approved only after agreeing to restrictive conditions. In late October, Beijing combined China’s two largest shipbuilding companies into an even larger national champion. Two regulators approved the merger, but approval from the state market regulator is still outstanding; we expect the deal to be approved without any conditional requirements, similar to the combination of China’s two national rail manufacturers in 2015.

There were fewer foreign-involved deals for authorities to review this quarter: the number of foreign-involved deals decreased to 138, the largest year-on-year (yoy) drop (~26%) since 2012. With growth expectations falling and lingering concerns about China’s business environment, China will need to do more to attract stable foreign investment inflows.

China’s judicial system remains too opaque to verify Beijing’s claims that intellectual property protections have materially improved. Chinese courts did publish many more competition-related cases this quarter, increasing the proportion of cases published from 5% of total cases handled by the courts in 1Q2019 to 15% in 2Q2019 (see Judicial System Transparency). Most newly published cases are concentrated in the copyright area, likely related to the government’s plan to revise the Copyright Law this year. However, the courts erased hundreds of other competition-related cases involving the Anti-unfair Competition Law and the Patent Law, showing continued limits to judicial transparency.

New World Bank data show that market entry barriers in China have fallen significantly. On October 24, the World Bank published its 2020 Doing Business report, ranking China 31 out of 190 economies in ease of doing business, up 15 spots from last year. The upgrade was mostly the result of simplified procedures to obtain construction permits, consistent with our observation of China’s continuous efforts to streamline administrative procedures in the past few years. Thanks to these efforts, growth of new business registrations accelerated to 9.4% yoy in 2Q2019 (see Market Entry and Exit), its strongest growth in more than a year.

More interesting, the World Bank also upgraded China’s scores in resolving insololvency and protecting minority investors. We have also observed rising bankruptcy filings over the past two years (see Spring 2019 edition), indicating lower market exit barriers and better competition conditions. For years, government subsidies and soft budget constraint guidance to banks have kept inefficient firms alive, enabling them to operate with very low costs or risk, to the detriment of others. Allowing inefficient firms to exit has helped support firm pricing power, which improved for both listed state-owned enterprises (SOEs) and private firms this quarter (see Pricing Power Index). While these are positive developments, it is important to note that indicators remain at historical lows.

Supplemental 1: Results of Merger Reviews

[Bar chart showing number of cases approved without condition and those with penalties from 2Q2014 to 2Q2019]

Source: Source: State Administration for Market Regulation, Rhodium Group.
**Supplemental 2: Judicial System Transparency**

Number of court cases on competition and intellectual property
disclosed

Source: Judgements Online, Supreme Court.

**Supplemental 3: Market Entry and Exit**

Millions

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

**Supplemental 4: Pricing Power Index**

Percentage

Source: Bloomberg, Rhodium Group.

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**Policy Analysis**

Beijing seeks to portray a fair Chinese operating environment. On October 24, the State Council published an “Ordinance on Optimizing the Business Environment” with the aim to “provide institutional protection for all market entities’ investments and business operations through legislation,” effective January 1, 2020. The Ordinance was first circulated in draft form and reportedly shared with U.S. negotiators during trade talks earlier in October. The Ordinance is a high-level declaration of intent, but its substance is not new, raising questions about how enforcement of commitments will change.

The Ordinance restates the 2013 Third Plenum Reform Decisions pledge to “reduce government intervention in the market to the greatest extent” and protect the “autonomy, property rights and other legitimate interests of businesses.” It promises to continuously lower market entry barriers, step up antitrust enforcement, protect intellectual property, lower taxes, regulate government fees and funding, promote lending to private and small- and medium-sized enterprises, and more. These goals are familiar to close observers and have been covered in previous Dashboard editions: past campaigns have come up short due to lack of enforcement (see, e.g., Merger Reviews).

Two measures on enforcement are found in the Ordinance, though neither is likely to be effective by itself. First, the State Council details rules on administrative procedures and government transparency but does not provide new incentives for officials to implement them. Improving transparency appears a stretch even for the Supreme People’s Court (see Judicial Transparency). Second, the Ordinance relies upon the “fair competition review” mechanism to reduce government intervention launched in 2016. This mechanism requires all government bodies to “self-review” their policies, clean up anticompetitive policies, and report back to the central government periodically. The mechanism has already led to amendments to at least 20,000 local-level policies throughout 2018 but has not significantly improved our indicators.

Local government antitrust enforcement bears monitoring over the coming months. As discussed in the Summer 2019 edition, the State Administration for Market Regulation (SAMR) authorized local governments to enforce antitrust rules in their own jurisdictions starting September 1. State news outlet Xinhua reported on September 23 that the central government and at least six provinces (Jilin, Hebei, Jiangxi, Yunnan, Hunan, Henan) are planning to investigate anticompetitive behaviors in sectors including drugs and internet-based

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services. These investigations could either sow or dispel cynicism: the business environment in China can only be improved if the government truly tackles anticompetitive practices rather than protecting local champions.
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

![Graph showing the quarterly assessment and outlook for external financial liberalization](image)


- Our assessment remains negative this quarter. Gross cross-border capital flows as a percentage of GDP declined to new lows, and speculative capital outflows have picked up relative to portfolio capital inflows as China’s currency has depreciated.

- Foreign acquisitions are declining amidst a broader drop in mergers and acquisitions (M&A) activity, indicating weakening foreign appetite for longer-term investments in China.
• Commitments to remove foreign equity caps on asset management firms and securities firms have clear timelines for 2020. Overall, investment opening is primarily focused on encouraging inflows rather than two-way cross-border transactions.

This Quarter’s Numbers

China’s financial system continues to rely on domestic investment, rather than increasing engagement with international capital markets. Cross-border capital flows continued declining as a proportion of China’s economy in 2Q2019, reaching a record-low level of 4.26% of GDP (External Financial Liberalization). Both inflows and outflows trended lower relative to the size of the economy this quarter, highlighting the limits to implementing liberalization promises so far, and the urgency of doing so.

The outflows that are persistent appear to be primarily speculative in nature, consistent with the 2Q2019 depreciation of the currency after trade tensions escalated in May. Companies and households are still trying to get money out of China: errors and omissions under the balance of payments, which capture “hidden” outflows outside legal channels, showed an astonishing $841.6 billion in outflows over the past four quarters, a new record (see Net Capital Flows). In addition, foreign equity investment reported a net $19.1 billion outflow in 2Q2019, the first outflow since the stock market crash in the second half of 2015 and the largest-ever quarterly outflow from China’s equity markets.

While official foreign reserves did not decline (see Currency Intervention), the central bank has intervened to resist rapid currency depreciation through less obvious channels, primarily by encouraging Chinese banks to borrow U.S. dollars abroad. Major tightening of capital controls to temporarily slow outflows would likely increase market fears about China’s financial stability and pressure the currency to depreciate further. Internationalization of China’s currency has not advanced, in part because of continued concerns about the imposition of capital controls: only 1.94% of international financial transactions used the renminbi in 2Q2019 – basically unchanged since 2015 (see Globalization of China’s Currency).

Despite policymaker efforts to attract portfolio inflows, Chinese investors sent more money into overseas financial markets, while inflows from foreign investors shrank. Portfolio investment reported a smaller surplus ($3.6 billion) in the second quarter than in 1Q2019 ($19.5 billion), lower than the 2018 average (see Breakdown of Cross-border Financial Flows). Bond inflows did pick up strongly to $39.5 billion, but this still may be a response to China’s weakening economy (that is – betting on more stimulus) rather than longer-term factors such as the inclusion of Chinese securities within the Barclays Bloomberg Global Aggregate Index starting in April.

FDI inflows are unpredictable at present, falling to $34.3 billion in 2Q2019 from $47.6 billion in the first quarter, eroding China’s surplus. In 2Q2019, while overall M&A deal flow picked up, the foreign-involved share decreased from 20% last quarter to 13% this quarter (see Foreign Appetite and Market Access). Recent efforts to abolish equity caps and allow greater foreign equity ownership in certain industries do not seem to have a meaningful impact yet on foreign deal making in China.

Supplemental 1: Net Capital Flows

USD billion

Supplemental 2: Breakdown of Cross-Border Financial Flows

USD billion

Source: State Administration of Foreign Exchange.
Policy Analysis

China’s need to attract capital inflows has influenced both financial sector opening and People’s Bank of China (PBOC) rhetoric. In late September, in a press conference ahead of the 70th anniversary of the People’s Republic of China, PBOC Governor Yi Gang commented that China should “cherish the scope of normal monetary policy” while other global central banks were eager to cement its position as “the highlight of the global economy and one the market should admire.” This is unusually direct language, essentially calling for additional capital inflows by comparing China’s monetary policy trajectory with that of other central banks and suggesting that Yi understands the importance of attracting significant capital inflows.

To foster needed inflows, Chinese authorities have offered timelines for financial sector liberalization steps. The securities regulator announced China will scrap foreign ownership limits on futures companies starting on January 1 of next year and on fund management firms starting April 1, 2020. Securities companies will see equity caps scrapped starting December 1 of next year. These are positive, concrete steps following through on earlier promises of liberalization, but the critical issue remains whether or not they will actually encourage inflows and additional investments in these sectors, given the broader change in the political climate surrounding China’s relations with the rest of the world, and the trade dispute with the United States in particular. A few foreign majority stakes in securities joint ventures have been approved, but the operating environment for wholly foreign-owned and operated enterprises in these sectors remains untested.

China continued to advance measures aimed at improving the domestic business environment for foreign investors in mid-2019. In October, Beijing circulated a draft version of the FDI law implementation measures, which received a positive response from the foreign business community. The State Council also reaffirmed several commitments to improving the domestic environment for FDI in October 2019. Premier Li Keqiang reiterated during a State Council regular meeting that China will continue to open up to foreign investment, promote ease of investing, protect foreign investor interests, and strengthen investment promotion on the local level. The actual impact of these efforts on FDI inflows will depend on whether the final implementation and enforcement details can meaningfully improve the business environment and boost foreign investor confidence after the new FDI law goes into effect on January 1, 2020.

Inflows continue to materialize, but portfolio inflows in particular areas are at risk of reversing unpredictably. While China is being included in additional bond indices,
such as JP Morgan’s GBI-Emerging Markets index (at the 10% level, expected to begin at the end of February 2020), the FTSE Russell recently declined to include Chinese securities within its primary bond index, citing concerns about market liquidity and foreign exchange clearing and hedging instruments.

Attracting additional inflows is now critical for China. Capital outflows have intensified, shown by the record volume of errors and omissions-related outflows over the past year. China’s central bank must gradually withdraw from intervening to defend the currency over time to allow both exchange rates and interest rates to become more responsive to market forces. On the one hand, the currency faces fundamental pressures to depreciate, and a more market-driven exchange rate will make investment in China more attractive. On the other, the pace and timing of that depreciation could be perceived as retaliation in the trade dispute, fueling concerns about political control of the exchange rate that would discourage foreign investment. Thus, in motivating inflows, the PBOC faces a delicate calculation: how much exchange rate flexibility it can permit versus how that flexibility is perceived by investors.

The growing political divide between China and the rest of the world may become a significant influence on those flows over time, particularly if market-driven investors start to see negative political costs attached to both direct investments in China and portfolio investments in Chinese securities. This concern is particularly relevant given the political crisis in Hong Kong and Beijing’s growing threat to the independent legal and institutional environment in the city, since many of China’s portfolio inflows via the Bond Connect and Stock Connect programs flow through Hong Kong, and the city reflects a significant channel for wholesale borrowing by Chinese banks as well. In November, a bipartisan group of members of the U.S. Congress introduced legislation to block government pension funds from investing in Chinese stocks. At present, however, there seems to be little momentum behind impeding U.S. outflows into Chinese assets.
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

• We modestly upgrade our assessment because air pollution levels declined and renewable energy use rose, while water pollution levels remain unchanged.

• China’s renewable energy use expanded in 2Q2019, with the percentage of non-fossil-generated energy reaching a high point in our dataset. China also finalized regulations encouraging renewable power use and development, including a renewable energy credit trading system.

• China’s environmental plans for winter 2019 set ambitious pollution reduction targets, but weakening economic conditions will limit local authorities’ willingness to curb industrial production and coal use to meet those targets.

This Quarter’s Numbers

China made small strides reducing pollution this quarter. Air pollution decreased across the five cities we track in 2Q2019 compared to last year (see Environmental Impacts), but progress was not uniform. Particulate matter (PM 2.5) levels increased in the northern city of Shenyang. Overall water pollution levels remained unchanged this quarter, with local water quality remaining a problem. The Ministry of Environment and Ecology (MEE) found that water quality in 178 monitored areas was still below standard as of June 2019 due to a lack of water treatment infrastructure. Politburo Standing Committee member Li Zhanshu noted that poor enforcement of the Water Pollution Prevention and Control Law was also hurting water quality.

As air pollution declined this quarter, non-fossil energy use surged: 30% of power came from sources such as wind and solar, marking the best quarter since 2013 (see Non-Fossil Generation). Non-fossil energy use was strong even for a second quarter, when environmental conditions are usually more favorable for renewable power. As China’s National Energy Administration (NEA) reported in July, overall energy consumption growth slowed during the first half of 2019; new renewable energy plants were able to meet energy needs without a substantial increase in coal and natural gas generation. Despite improvement in renewable energy uptake, China’s efficiency in harnessing wind energy did not improve in 2Q2019 (see Wind Energy Curtailment). Around the same amount of wind power was wasted this quarter because it could not be transmitted to the electrical grid.

Meanwhile, New Energy Vehicles (NEV) Sales rose in 2Q2019, accounting for 5% of new auto sales even as overall auto sales declined. With NEV subsidies set to expire in July, producers offered huge deals to sell down inventory, and local policies still provide NEV purchase incentives, such as preferential access to a license plate in some large cities like Beijing. After July, sales plummeted, and the next Dashboard cycle will see a dramatic reversal of the NEV sales picture.

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


Supplemental 4: Non-Fossil Electricity Generation
Index


Policy Analysis

Authorities prioritized renewable energy policy this quarter, issuing guidelines to provincial authorities to encourage renewable utilization and construction. New winter air pollution reduction targets are more ambitious for most cities in northern China, but policy allowing local governments to set their own industrial production curbs is mostly unchanged from last year, and many cities may find it difficult to set strict production cuts amid weak economic conditions.

On May 20, the National Development and Reform Council (NDRC) and the NEA released final regulations establishing a national renewable energy quota system requiring grid companies and provincial energy regulators to meet a minimum level of renewable energy utilization. The regulations aim to harness existing renewable assets and build new ones. Provinces that miss their renewables quotas can buy credits from other provinces to make up the gap. However, if they are unable to meet their quota – through either their own generation or credits – they may face sanctions and restrictions on building new fossil fuel plants. The regulations are a major step toward better utilizing China’s increasing renewable capacity. As our spilled wind indicator suggests, China has made some progress in putting more of its renewable energy on the grid, but not at the needed scale to fully utilize capacity.

Even as Beijing seeks to encourage renewable energy use, it is also relaxing curbs on the coal industry. A March 27 notice from the NEA relaxed a ban on new coal plants, effectively doubling the number of provinces eligible to construct new coal assets to 16, including key polluters like Hebei and Shanxi. National officials also signaled they would not force conversion of residential coal heating to gas this winter, continuing a policy relaxation from last winter after ambitious targets and overzealous enforcement of coal-to-gas switching in 2017 led to heat, power, and gas shortages across the northeast. In July, the NEA announced it would prioritize heating supply this winter by allowing a wider scope of energy sources, like biomass and clean coal, to substitute for gas in coal switching this winter.

Authorities have started to outline winter pollution control measures. On October 16, the MEE released specific air pollution reduction targets for northern China, targeting a 4% average reduction across the key Beijing-Tianjin-Hebei region. Twenty-four of 28 cities in the region have higher pollution reduction targets than last winter, in an effort to reverse some of the region’s air quality deterioration from winter 2018–2019. While air quality targets are more ambitious, planned production cuts appear insufficient to meet them. The MEE eliminated blanket production cuts last winter, as local officials wanted to avoid economic disruption in northern manufacturing areas and were struggling under weaker demand conditions. The 2019–2020 plan gives local officials substantial leeway in formulating production cuts based on local environmental conditions, but if local governments do not set and enforce effective production restrictions, northern China could see a repeat of last year’s high pollution levels. Provincial officials had until the end of October to finalize their own plans.
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 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 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

![Graph showing the China ICOR and International Best Practice from 2014 to 2019.](image)


- We slightly upgrade our assessment. The first effective bank default at Baoshang Bank marks an important step toward market pricing of credit risk.

- Our primary indicator showed the financial system becoming less efficient even as economic growth moderates. Credit growth is stable for now but may slow as banking sector risks weigh on shadow banking activity.

- The central bank shifted official lending rates to a more market-based system. However, there were no meaningful steps toward reform of deposit rates or
unifying bank funding rates to prevent regulatory arbitrage.

**This Quarter’s Numbers**

On balance, financial indicators showed no change in reform progress this quarter, though we expect data will reflect positive policy developments over the next year. Our primary indicator continues to show deteriorating efficacy within China’s financial system. The **Quarterly Incremental Capital Output Ratio** (QuICOR) rose to 7.41 in 2Q2019 from 7.21 at the end of 2018, reaching its highest level since at least 2011. The broader slowdown in China’s economy, from 6.4% year-on-year real GDP growth to 6.2% in 2Q2019, drove the QuICOR’s rise, rather than resurgence in capital growth. In fact, in the first half of 2019, capital formation accounted for its smallest-ever share of real economic growth, consistent with a tighter post-deleveraging financial system. Even so, capital produced less new economic output this quarter.

Overall **Growth in Credit** picked up early this year in response to monetary-easing steps and continued rising in 2Q2019 to 10.9%. The deleveraging campaign to reduce systemic financial risks has continued in China, but the pace of that effort has moderated since the middle of 2018, allowing credit growth to rise. This is not necessarily a negative signal for financial reform, as the sharp slowdown in shadow financing growth last year was not sustainable without a significant increase in financial risks. Current credit growth in the 9%-11% range is far below the 16.6% growth seen only three years ago, though it still adds to economy-wide leverage rather than moderating the debt load.

Consistent with continued People’s Bank of China (PBOC) monetary easing, shadow banking funding costs have dropped close to the level of banking system funding costs, with the spread between our two indicators narrowing to only 7 basis points (0.07%, see **Interbank Lending Rates**). This is due to a slight increase in banks’ funding costs this quarter. By tolerating a bank failure in May (Baoshang Bank), Beijing caused big banks to be more conservative lending to smaller institutions, starting to push up the price of credit for riskier players. This is necessary and—ultimately—healthy, though it means stress in the near term.

Regulators advanced more market-driven interest rate reform this quarter, but household savings in China still see the same policy-controlled rate of return on their deposits (see **Return on Savings**). Until the PBOC allows banks to offer more market-driven returns on deposits, interest rate reform will remain incomplete and incentives driving riskier financial behaviors will remain in place.

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**China Dashboard Fall 2019**
Better market-driven pricing of credit risks within financial institutions is an essential component of financial reform by breaking the implicit guarantees that are widespread across China’s financial system. In this respect, the takeover of Baoshang Bank by regulators was an important positive reform step. Corporate and interbank depositors lost money as a result of the seizure, exposing depositors to the credit risk of the bank itself for the first time since 1998. As a result, banks have reduced interbank lending activity, with larger banks more reluctant to provide financing to smaller and riskier banks out of fear they will not be paid back in full. This can help reduce overall financial system growth over time by winding down some of the riskier institutions within the system.

Since Baoshang’s takeover, two other banks have been restructured—the Bank of Jinchou and Hengfeng Bank—and more will likely follow. The most important question for financial reform will be how authorities manage those bailouts, and where the costs are distributed throughout the financial system. Some market discipline is necessary to prevent banks from relying on riskier liabilities to expand, but too much could lead to rapid liquidations of assets and a contraction in credit. New measures aim to slow banking system growth and prevent future defaults. The asset management rule, which will be fully implemented by the end of 2020, will force banks to meet stricter capital adequacy requirements. Beijing is also placing more pressure on banks’ shareholders by limiting banks’ interbank exposure as a proportion of their total capital base. These policy changes indicate a desire to contain financial risks despite the potential impact on overall economic growth.

Financial system liberalization is proceeding: the PBOC has continued to strongly encourage foreign investors to increase their holdings within China’s bond and stock markets. In September, the State Administration for Foreign Exchange scrapped formal limits on inbound flows under the Qualified Foreign Institutional Investor (QFII) program. The move is symbolically important, but its practical impact is minimal given that more flows transact through the Hong Kong–based Bond Connect and Stock Connect channels. In addition, PBOC Governor Yi Gang commented in September on the importance of China maintaining a conventional monetary policy stance while other global central banks are reducing rates and pursuing unconventional policy measures. Presumably, his comments are intended to attract foreign inflows by arguing that Chinese interest rates will be higher than those in the rest of the world. This indicates a continued willingness to liberalize the domestic financial system and permit greater foreign influence in setting domestic

Policy Analysis

 Authorities are trying to force financial players to be more diligent and market based in pricing their capital dealings by tolerating defaults and changing the way interest rates are set. Formally, interest rates have been liberalized since 2019, with banks able to price deposit and lending rates according to market signals. But informally, there have been de facto ceilings on deposit rates and local governments have been able to pressure banks to keep lending rates at or below benchmark rates. Cheap bank credit allowed local, unprofitable companies to keep rolling over debt and keep production up, creating the appearance of strong growth.

In mid-August, the PBOC introduced reforms tying the loan prime rate (LPR) to a medium-term funding rate for banks. This theoretically allows market-driven rates to play a greater role in loan pricing by allowing banks to price loans based on the new LPR, which the PBOC sets monthly, rather than the previous benchmark rates. While a modest step forward in interest rate liberalization, the fact that banks’ funding rates, particularly deposit rates, have not moved toward greater market-based pricing disappointed expectations.
interest rates, even though the current level of foreign investment remains low (for example, only 2.1% in the bond market; see Foreign Held Bonds).

While foreign investors have long pushed for more open access to China’s economy, which features one of the largest bond markets in the world and a growing stock market, increasing exposure to China’s financial markets through bond and equity index inclusion has also prompted backlash in the United States. Earlier this year, a bipartisan group of U.S. congressional representatives called for government pension funds to disinvest from indexes that track Chinese companies that are linked to “China’s efforts to steal American innovation, undermine fair competition, increase threats to U.S. national security and economic security,” according to Senator Marco Rubio. At present, however, there seems to be little momentum for action to impede U.S. outflows into Chinese assets.
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

<table>
<thead>
<tr>
<th>Primary Indicator: Local Governments Expenditure-to-Revenue Ratio 4qma, percent</th>
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<tr>
<td>Expenditure/Revenue Ratio with Extra-budgetary items</td>
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<td>Expenditure/Revenue Ratio with Budgetary Items Only</td>
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- We modestly upgrade our assessment of fiscal affairs reform: local governments are slashing property-related spending while replacing riskier and more expensive shadow banking borrowing with formal bond issuance.

- Local governments narrowed the augmented fiscal gap in 2Q2019 after they spent less on shantytown redevelopment, but they still outspent their budgetary resources.

- Beijing’s tightening against the property sector, if continued, and retirement of the shantytown
redevelopment program in 2020 are conducive to long-term improvements in localities’ fiscal balances.

This Quarter’s Numbers

Local governments’ fiscal picture improved this quarter. The augmented Local Expenditure-to-Revenue Ratio fell to 15.6% in 2Q2019, its lowest level since 1Q2015, from 15.4% in the previous quarter and 14.2% a year ago. 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 extra-budgetary revenue by 30%.

Reduced spending on land and property-related items was the key driver of improvement this quarter. Growth in local government fund expenditures, which can include land, property-related development costs, and revenue-generating infrastructure projects, slowed to 15.1% in 2Q2019 from a hefty 55.5% jump in 1Q2019 linked to the unseasonal surge in local government bond issuance, which has since moderated. Although the Finance Ministry has discontinued land revenue and expenditure data releases—a strike against fiscal transparency—available data confirm the ongoing slowdown in localities’ land-related spending.

The fall in expenditure is related to a change in the shantytown redevelopment program, which was originally designed to replace rundown homes with newer, improved housing. Since late last year, the government has gradually transitioned from compensating resettled residents with cash, which residents use to buy new homes at market value, to offering newly constructed housing. As constructing housing is far cheaper than paying market value for it, the policy change greatly reduces localities’ spending responsibility.

Increasing revenue also helped (see Sources of Local Government Revenue). Land sales revenue improved to 7.7% growth in 2Q2019 from a contraction of 9.5% in 1Q2019 as localities stepped up collection of land-related fees to fill their own fiscal gaps. Land revenue and expenditure are typically closely correlated as local governments spend money to acquire and develop land and then sell it to developers. The divergence in land spending and revenue seen this quarter is rare and is best explained by the fall in shantytown redevelopment spending and the intensification of land fee collection. Local government bonds also contributed to stronger revenue this quarter, thus continuing to lighten heavy local implicit debt burdens.

The improvement in fiscal balance also saw a modest narrowing of augmented Fiscal Deficits this quarter, falling to 14.4% of GDP from 14.5% in the first quarter. While the off-budget fiscal picture improved, the budgetary deficit worsened, reflecting limitations of the current fiscal model in maintaining more sustainable budgetary outlays. Spending growth on transportation, urban and rural communities, and science and technology barely changed this quarter with a modest uptick in environmental spending; although as a share of total government expenditure, social spending in most categories has fallen since 2Q2018 (see Government Social Expenditures).

Supplemental 1: Sources of Local Government Financing


Supplemental 2: Fiscal Deficit Measures

Source: Ministry of Finance, Rhodium Group.
property policy and retirement of the shantytown redevelopment program will substantially ease local government spending expectations in the long run.

Beijing has also renewed tightening efforts against local governments’ implicit borrowing after relaxing its deleveraging campaign in late 2018 so local governments could step up spending to support economic growth. As soon as growth appeared to stabilize in 1Q2019, policymakers tightened the reins again. The banking regulator issued a circular reinstating key deleveraging measures focused on local governments and the property sector. In June, the government banned contractors from fronting funding for local government investment projects, and the Finance Ministry resumed inspections on public-private partnership (PPP) projects that add to local governments’ implicit debt. These measures will force localities to reduce spending or to borrow money from official channels or both, which is conducive to narrowing fiscal gaps.

The improvement in the fiscal balance will falter in the third quarter as governments run out of room to issue more revenue bonds. Policymakers are considering boosting bond issuance in the fourth quarter to offset a slowing economy, which would sustain local fiscal needs through the end of the year but leave the long-term picture unresolved.

Policy Analysis

Beijing has tightened policy toward the property sector, indicating a higher tolerance for a broader economic slowdown. In July, the Politburo made clear that property would not be used as a short-term stimulus to spur growth as in previous cycles. Since then, regulators have unveiled a slew of measures, including the central bank’s pledge to keep mortgage rates unchanged despite the August rate reform that should reduce lending rates for the rest of the economy. Both the central bank and the banking regulator have instructed banks to control or even reduce loans to property developers. If Beijing remains committed to reining in the property sector, local governments will have no choice but to rely less on selling land to developers for revenue growth and by extension will spend less on land development.

In addition, the shantytown redevelopment program is scheduled to be retired after 2020, removing a major fiscal burden. Together, land and property-related spending drove the explosion of local government fund deficits from 2.41 billion yuan in 2015 to 2.3 trillion yuan in 2019, and in 2018 land-related spending accounted for 90% of governments’ fund expenditure. That ratio fell to just 76% in the first half of this year, suggesting that tighter
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

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<td>Country</td>
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We downgrade our assessment of innovation reform for the first time since the inception of the China Dashboard. Dismal auto sector performance...
significantly dragged down China’s overall innovative industry growth.

- Weakening domestic and external demand growth is weighing on innovative industries: all but one industry we track are trending downward in 2Q2019.

- Beijing committed to making the market more open and competitive, stopping forced technology transfer, and protecting intellectual property (IP). But major implementation uncertainties, and a parallel emphasis on technology self-control, obscure the outlook.

This Quarter’s Numbers

China’s innovative industries are no longer certain to outperform the rest of the economy. Our primary indicator, Innovative Industry Share in Industrial Value-added (IVA), showed no change at 33.5%, ending its 14-quarter growth streak. Six out of the seven innovative industries we track saw value-added growth slow from 1Q2019. Three industries (autos, universal equipment, and special purpose equipment) also underperformed overall IVA growth.

The auto sector was the single biggest drag on China’s industrial innovation performance: auto IVA growth fell to an all-time low of -2.8% (or 0% on a four-quarter moving average basis, see Industrial Value-added Growth Rates for Specific Innovative Industries). The auto sector has been in decline since 2017, though in 2Q2019 stricter emissions standards for carmakers contributed to an especially weak quarter.

Even industries that are better able to weather slowing economic growth due to state presence and strong policy support faltered in 2Q2019. Two such sectors—universal equipment and special purpose equipment—slowed especially sharply. Universal equipment IVA growth slowed to 2.4% in 2Q2019 from 14.1% in 1Q2019, while special purpose equipment IVA slowed to 4.3% from 16.4%. Because these two industries typically supply capital goods (e.g., machine tools) to other manufacturing industries, their weakening performance suggests slowing industrial activity across the board.

Policy Analysis

The slowdown in China’s innovation-related industrial activities may be a wakeup call for Beijing to rethink its innovation strategies. Policymakers in the past often admitted weakness and flawed designs, but the urgency to act was never too great because headline growth was still strong. As Beijing’s old innovation model—top down, selective, and often distortionary—finally started to lose momentum, policymakers and political leaders in mid-
2019 began to reexamine China’s industrial policies. Authorities acknowledged existing problems and pledged some market-oriented improvements, such as nondiscrimination and intellectual property protection for all entities, but the message is not fully consistent.

The Deepening Reform Commission, the institutional decision maker on China’s reforms, passed an Opinion on Promoting Deep Collaboration and Synchronized Development between Advanced Manufacturing and Modern Services in early September promoting industrial upgrading by deepening linkages between the service sector and the manufacturing sector. Several days later, while touring a state-owned equipment manufacturer in Henan province, President Xi Jinping reemphasized the importance of indigenous innovation, a phrase associated with technology self-dependence and the pursuit of technonationalistic practices such as forced technology transfer in the past. These statements underscore Beijing’s determination to ascend the high-tech curve in manufacturing, as a technology decoupling with the United States becomes increasingly real. Our primary indicator does not distinguish between indigenous or other drivers of innovation and so could improve even if Beijing turned more concertedly toward a tech self-sufficiency model.

The impacts of U.S.-China high-tech decoupling are still taking shape. In trade, China’s information and communication technology (ICT) and machinery exports to the United States decreased by 8% year-over-year (yoy) in the first half of 2019 but increased to the rest of the world, which at least partially offset the loss of U.S. demand and prevented China’s total exports of these tech-intensive goods from contracting. In the investment space, while Chinese foreign direct investment (FDI) to the United States dropped sharply in 2019, Chinese venture capital investment, which is more concentrated in tech and IP, has held up far better even though heightened U.S. regulatory scrutiny has added uncertainty. More important for China’s innovation outlook is how global manufacturing supply chains will shift. While we expect decoupling will accelerate supply chain migration from China to other destinations, the actual impact on China’s innovation capability will be contingent on China’s domestic policy response, as well as the outcome of bilateral talks.

On the positive side, the government acknowledged significant market distortions for foreigners caused by the nation’s industrial policies and pledged to change. In September 2019, the Development and Research Center (DRC) of the State Council and the World Bank published a joint report (“Innovative China: New Drivers of Growth”) recommending a reshaping of China’s industrial policies to foster innovation. Specially, the report emphasized that industrial policies should not preclude market competition or fair treatment. While this report alone is insufficient to facilitate substantial reform of China’s industrial policies, it is an important, if long overdue, government acknowledgment of the existence of favoritism, distortions, and anticompetitive regulations in industrial policy formation and implementation.

Other recent policy signals suggest stronger momentum toward reforming industrial policies. The October 8 State Council Executive Meeting passed a draft “Ordinance on Optimizing the Business Environment,” which aims to ensure “all types of business entities have equal access” to key inputs like credit, land, and licenses and “enjoy state support policies equally” (see Competition for more details). Such language appears to directly address discriminatory elements of China’s innovation-boosting strategy, which typically disqualifies foreign and domestic private investors from accessing preferential financing or state aid. The State Council Executive Meeting one week later (October 16) went one step further by announcing that no level of government should “force foreign investors and companies to transfer technology, explicitly or implicitly,” suggesting more central oversight over local interference in business transactions. The measures also promise to establish a national platform for protecting market entities’ rights and interests, including property rights. In late October, the State Council formalized the draft with a January 1 effective start. While this regulation is laudable and nontrivial, institutional incentives behind forced technology transfers require time and more than just administrative measures to resolve.
Labor

The Story So Far

From the birth of the People’s Republic of China in 1949 to 2019, 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

![Graph: Wage Income of Urban Households, Wage Income of Rural Households, Wage Income of Migrant Workers, Benchmark]


- We downgrade our labor reform assessment: labor conditions weakened across the board, and policy support is lacking.

- Migrant and rural wage growth deteriorated alongside a more serious drop in job creation. Despite this downturn, the central government has slowed safety net spending.

- Beijing is supporting employers through tax cuts, lending quotas, and reduced social security payments, but these measures are indirect and help workers in the medium term. Healthcare policy saw substantial improvement, extending access and reducing costs especially for poorer citizens.
This Quarter’s Numbers

The economic slowdown underway in China, driven by softer lending, investment, and trade growth, has led to deterioration in labor conditions across the board in 2Q2019. These factors are weighing on the willingness and ability of firms to hire new workers and raise wages. Anemic safety net spending in this period indicates that China’s fiscal institutions are limited in their capacity to support workers affected by weaker economic and financial conditions. The government is thus failing to improve worker welfare.

Our primary indicator, Wage Growth Relative to GDP, shows that wages for urban, rural, and migrant workers fell compared to total economic growth, with migrant wages growing 33% slower than GDP. Employment data are more concerning. New Job Creation registered the biggest decline since mid-2015, with 220,000 fewer net jobs created over the past four quarters than in the previous year. The ratio of job openings to applications dropped in all regions, and very sharply in eastern and western China, further suggesting that employers are paring back (see Labor Demand-Supply Ratio). Companies appear hesitant to add to payroll amid the current slowdown and future uncertainties.

Despite labor market weakness, central government support for workers and their families is slowing. The growth of central government transfer payments, a component of per capita disposable income which includes unemployment insurance and welfare, slowed to 6.8% year-on-year in 2Q2019, down from 7.3% in the previous quarter and more than 11% growth in 2017. One positive development is that a greater portion of transfers is going to rural residents compared to urbanites, which will help narrow the large income gap (see Rural-Urban Household Income).

Other forms of government support that would help offset wage and employment pressures either remained flat or deteriorated in 2Q2019 (see Social Spending). Beijing announced large income, value-added, and corporate tax cuts to stoke demand for more workers and consumer goods. While these cuts may indirectly support middle- and lower-income workers over time, they also deprive local and the center governments of funds needed for redistributive social spending. On balance, these indicators suggest the government is not providing enough direct fiscal support to help households maintain spending while they wait out wage cuts, find other jobs, change career fields, or pursue higher education.
Healthcare policy improved in 2Q2019, with officials announcing plans to expand access and reduce costs especially for lower-income households. On August 20, the National Healthcare Security Administration published the new catalog of drugs covered by the national healthcare insurance plan. The number of drugs fully covered by insurance will rise to 640, an increase of 46 since 2017. The National Health Commission announced twin goals of covering 90% of poor citizens' spending on serious illness treatments and ensuring that 90% of citizens who get sick see a doctor by expanding hospital access. Finally, the government expanded a pilot that centralizes procurement of basic drugs to all provinces, which will increase government bargaining power and reduce drug prices. On the whole, recent policy developments will help address long-term issues by encouraging lending to smaller firms, shoring up funding for social safety nets, and reducing healthcare costs. But these measures do not adequately provide immediate support for workers in the face of a weakening economy.

Policy Analysis

China's households are facing not only fewer employment opportunities and lower income growth but also higher costs of living related to tariffs, food prices, and housing. Though recent high-level policy rhetoric prioritized improving labor conditions, the policies advanced this period will likely only help the country's workforce in the medium term.

Building on the announcement of the "employment first" strategy in March, Premier Li Keqiang at a September State Council meeting emphasized the importance of shared welfare, whereby rural and migrant workers enjoy income growth on pace with economic growth. So far this year, Beijing has taken a supply-side approach to boost income growth by reducing costs and increasing lending to smaller, private companies so that they increase employment and wages. In March, the National People’s Congress targeted 2 trillion yuan in income, value-added, and corporate tax cuts for the rest of the year (see Spring 2019 edition). Over the first half of the year, China's central bank continued to direct banks to reduce borrowing costs for and increase lending to private firms. These indirect measures have had little identifiable impact and have only chipped away at the national tax base.

Insufficient tax revenue remains a key constraint on government social security spending. To address this shortfall, Beijing is accelerating the transfer of state assets to social security funds. On September 20, the Ministry of Finance (MoF) announced that all large and medium-sized central and local state-owned enterprises must transfer 10% of state equity to the social security funds by the end of 2020, adding an explicit deadline to policy statements made in 2017. This is a positive but limited step. The MoF indicated that the funds will benefit mostly by earning dividend payments from SOEs, which are low, and they will mostly be unable to sell the related equity.
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)

- We downgrade our assessment of land reform this quarter, as pilot programs have hit a wall and new policies suggest little intention of further reform.

- Rural nonagricultural land transferred at market prices still accounts for just 0.1% of China’s total rural nonagricultural land and will likely remain unchanged. Agricultural land transferred increased by only 5% from 2017 to 2018, slower than in previous years.

- The newly revised Land Management Law missed a key opportunity to expand reform. Instead, the revisions reinforce a strong government role in planning and allocating land. Policy toward agricultural land also turned more conservative.

This Quarter’s Numbers

Land reform moved further negative this quarter. China’s 2013 Third Plenum Decisions defined land reform as enabling the transfer of rural nonagricultural land at market prices—the same treatment as urban land. Since 2015, authorities have piloted this concept in 33 counties. If reform were advancing, market-based rural nonagricultural land transfer would expand beyond these pilots and would be legitimized on revision of the Land Management Law.

In reality, pilot programs have made little progress to date: our primary indicator shows that only 360,000 mu (60,000 acres) of rural nonagricultural land has been transferred at market prices, equivalent to just 0.1% of China’s total rural nonagricultural land area (see Marketizing Land). As described in the Policy Analysis section below, August revisions to the Land Management Law closed the door on scaling up land reform.

Rural agricultural land reform has also slowed. On September 5, the Ministry of Agriculture and Rural Affairs (MoARA) announced that 539 million mu (90 million acres) of China’s agricultural land—nearly 40% of the total—had been transferred via market mechanisms by the end of 2018. This represents a mere 5% increase since the end of 2017, compared with increases of 7% per year in 2016 and 2017, 11% in 2015, and more than 20% per year from 2010 to 2014.

Local governments’ heavy reliance on land sales for revenue remains a long-term obstacle to land reform. In the last edition, we observed that property market restrictions dampened land sales early in 2019, making this local revenue source less stable and therefore less of an obstacle to reform. We maintain that assessment this quarter. Although land sales have improved slightly from -10% growth in 1Q2019 to -1% in 2Q2019 (see Land Requisition Financials), the recovery is likely temporary given new tightening policies that will constrain developers’ ability to purchase land in the coming months.

Land reform should ultimately benefit rural residents. Allowing rural residents to transfer, lease, or mortgage their rural land in the same way urban land is marketed should help improve their property income, which accounts for only 2% of rural disposable income, compared with 10% for urban residents. However, rural property income grew by only 8.7% year-on-year this quarter, the slowest pace since 1Q2017. This is another indication that land reform has stalled.
Policy Analysis

Land reform policies disappointed this quarter. On August 26, the Standing Committee of the National People's Congress passed revisions to the Land Management Law, effective January 1, 2020. The revisions include some important changes but fail to address fundamental problems. On the positive side, the new law enables rural land owned by collectives to enter the urban market by removing a clause in the old law that “any organization or individual that needs to use land must use state-owned land.” In addition, the new law for the first time defines the scope of “public benefits” for which the state may requisition rural land and requires compensation to be “fair and reasonable” based on local conditions rather than agricultural output.

But the negatives outweigh the positives. The new law reinforces the strong role of the government rather than the market in planning and allocating land—in fact, the document does not mention the word “market” at all. Rural land is still owned by collectives and subject to strict conditions of transfer, making it impossible for rural and urban land to enter the market on equal terms. Local governments can still expropriate rural land for development with provincial government approval in the name of “public benefit.” And although the revised law requires “fairer” compensation to farmers who lose their land, the amount of compensation is still determined by the government, not the market, and the law aims to “ensure that farmers’ living standards are not reduced,” rather than materially improved.

The revised Land Management Law is particularly conservative on the reform of rural land for residential purposes. Each rural household is limited to owning only one piece of land for residential purposes; moreover, the
local government must approve the area and location of that land. These principles are reiterated in a September 20 MoARA document strengthening governance over rural residential land by explicitly prohibiting urban residents from purchasing rural residential land. Rather than using land reform as an opportunity to balance urban-rural development, the government is exploiting it to protect the urban property market, which would face significant downward adjustment should urban residents be allowed to purchase rural land.

Policy has become more conservative even on agricultural land reform, which used to move faster than nonagricultural land reform. On September 25, MoARA released a draft document concerning “Measures to Govern the Transfer of Rural Land Management Rights” for public comment. In the document, MoARA proposes tightening rules for purchasing rural land management rights with private capital in the name of financial risk prevention. If advanced, the policy would likely discourage private investment into rural land, further constraining rural property income growth.
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, SOEs 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

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developments. SOE revenue share in “normal” industries remains higher than 2018 average despite a minor decline this quarter.

- Private firms outgrew SOEs this quarter thanks to improved credit conditions, but the trend may reverse by year-end. Meanwhile, SOEs and private firms both saw worsening profitability as reform stalled.

- Policy developments in the review period generated a positive buzz in the headlines but as a practical matter have not yet reduced state control of SOEs or the economy.

This Quarter’s numbers

Our data show no net progress in SOE reform this quarter. In “normal” industries – those identified as non-strategic and from which Beijing pledged to withdraw state influence – SOE revenue share among listed firms decreased to 15.9% in 2Q2019 from 16.4% in 1Q2019 (see The State’s Share of the Take). This is a welcome move but is too minor to constitute reform: SOE revenue share in normal industries remains above the 2018 average. The change was primarily due to faster revenue growth among private firms than SOEs in the real estate sector, likely because private developers under financial stress were more aggressive in selling property units. Private firms also generated more revenue than SOEs in professional services, especially in areas related to information technology and advanced manufacturing.

At the same time, SOE revenue shares in “key” and “pillar” industries rose. SOE revenue share increased slightly to 84.5% in 2Q2019 in key industries that Beijing identifies as strategic to China’s national security and intends to exercise control. In pillar industries considered strategic to China’s economic development, SOE revenue share also increased to 45% despite talk of Beijing giving markets a larger role in these industries. More than 70% of A-share (Chinese stock market) listed company revenue is SOE revenue: that is the reality of state presence.

Private firms expanded faster than SOEs this quarter, but the trend may not last long. Total assets held by industrial private firms increased by 5% from 1Q2019 to 2Q2019 – more than the 2% gain for SOEs – causing SOE industrial sector presence to decline slightly (see Industrial Assets by Ownership). Improved credit conditions drove the expansion in private assets; however, credit growth is likely to slow in the second half of the year as lenders start to better price credit risks, meaning they will reduce borrowing to riskier private companies (see Financial System cluster). Over the next year, private firms may once again lose out to SOEs due to changing credit conditions.

Despite improved credit growth, all firms were less efficient this quarter. Returns on SOE assets slipped to 3.9% in 2Q2019 from 4.0% in 1Q2019, and for private firms returns fell to 6.8% from 7.1% (see SOE Return on Assets). This drove slight deterioration in the interest coverage ratio for SOEs and private firms to 4.3 and 4.4, respectively (see SOE Interest Coverage Ratio). Only serious reform can revive profitability of both SOEs and private firms. Without it, no amount of new borrowing will enable firms to comfortably service debts.

Supplemental 1: Industrial Assets by Ownership

Supplemental 2: SOE Leverage
Supplemental 3: Return on Assets
Percent


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

Source: Bloomberg, Rhodium Group.

Supplemental 5: SOE Share of Employment
Percent

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

Policy Analysis

SOE policies in the review period point to superficial reforms without relaxation of state control over the economy. On July 31, the Small Leading Group (SLG) on SOE reform announced the interim results of the “double-hundred actions” campaign. Since its August 2018 initiation, the campaign has focused on implementing mixed ownership and corporate governance reform in more than 400 central and local pilot SOEs by 2020. If faithfully implemented, this campaign would reduce state control in pilot firms and discipline state influence over their commercial decisions. But neither has been the case so far.

According to the SOE Reform SLG, under the campaign one-quarter of pilot SOEs have diversified their shareholding structure, one-third have attracted private capital into group companies, and more than half have attracted private capital into their subsidiaries. Together, pilot SOEs have completed around 30% of reform tasks and attracted 538 billion yuan ($77 billion) in private capital. This seemingly positive progress is inconsistent with our primary indicator: the campaign included 61 listed companies, but our indicator picked up ownership changes in only a few SOEs, with no meaningful change in SOE presence in the economy. One explanation is that the pilots did not sell large enough stakes, keeping the state as controlling shareholder. If that is the case, the campaign is not successfully reducing state control over pilot enterprises but rather bringing more private capital under state control.

State control over private-invested SOEs would not be so problematic if there were a proper governance structure in place to discipline state influence over the firms’ commercial decisions. The SOE Reform SLG claimed progress in this area: 77% of pilot SOEs have established boards of directors, and 94 of 221 (43%) solely owned SOEs have appointed enough external directors that they now account for more than half of board members. Central SOEs and local governments have also delegated more power to boards of directors and recruited more managers from the market. However, these improvements are likely inadequate to bind SOEs to market principles as they fail to address one fundamental problem: SOE leaders are still government officials subject to state evaluation; therefore, they are more likely to prioritize political objectives over commercial ones compared with private firm leaders.

One positive development is that SOEs are being asked to pay their due on social security. On September 20, the Ministry of Finance (MoF) set an explicit deadline – by the end of 2020 – for all large- and medium-sized central and local SOEs to transfer 10% of state equity to social security funds (as detailed in Labor Reform). The move may help address the country’s fiscal shortfall but will not help reduce state control over SOEs: the MOF intends that these obligations will be drawn from dividend payments by the SOEs, rather than by selling their equity to the public.
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.

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

- China has expanded and sought new free trade agreements (FTAs). Since 2002, China has signed 16 FTAs with 24 countries or regions; in 2016, trade with FTA partners (including Taiwan, Hong Kong, and Macao) constituted nearly 40% of China’s total trade volume and saw import duties reduced by RMB 42.2 billion ($6 billion) that year. Most recently, China signed FTAs with Georgia in May 2017 and with Maldives in December 2017. Beijing is currently negotiating seven other FTAs. In November 2019, China and 14 other nations concluded negotiations on the Regional Comprehensive Economic Partnership (RCEP) to reduce regional trade barriers; the pact is scheduled to be signed in 2020.

Methodology

To gauge trade openness, we assess the change in China’s imports using goods and services trade openness indexes. Scores higher than 100 indicate a growing role for imports relative to gross domestic product (GDP) since 2013 (i.e., relative liberalization of these goods and services), while lower scores indicate a falling role. Supplemental gauges look at other variables in China’s trade picture: current account-to-GDP ratios for goods and services, whether goods imports are consumed in China or just reexported, the services trade balance by component, exchange rates, and trade trends in overcapacity sectors.

Note: In this 2Q2019 edition, we are replacing the original Composite Trade Liberalization Index (CTL) with an alternate indicator due to missing data.

The indicator indexes the changes in the import/GDP ratios for selected goods and services relative to 2014. Our proxy line for goods trade measures ordinary trade imports—referring to imports that are not for processing, assembly, and reexport and are therefore a closer approximation of final import demand—less three types of goods: crude oil, iron ore, and integrated circuits. We exclude these goods from our ordinary trade proxy as China’s imports of these goods dwarf other imports in value and are highly sensitive to external price effects in such a way that they could distort this indicator. Ordinary imports face more tariffs and other trade barriers than
processing imports, for which tariffs are typically low or zero, thereby favoring export growth above import openness; improvement in China’s trade regime would rebalance toward more import growth catering to final demand.

For services, we included all subsectors except tourism and transportation, which are less reform sensitive given the longer-term trend of growing outbound Chinese tourism, overseas education, and resident spending abroad. The quarterly import/GDP ratio (four-quarter rolling sum) of each category was benchmarked to 2014 to coincide with the Third Plenum in November 2013. We attempt to isolate the trade liberalization variable by screening goods and services whose import growth is most constrained by policy, and by measuring imports over nominal GDP; ultimately, however, other factors including prices and inflation, cyclic patterns, competitiveness conditions, and global trade conditions may impact the indicator.

Quarterly Assessment and Outlook
Primary Indicator: Alternative Trade Liberalization Index
4qrs, 2014=100

- Our assessment remains neutral: goods trade became less open due to U.S.-China tariffs, while services trade openness improved modestly.

- Goods and services trade flows are slowing under bilateral trade tensions, causing China’s reported global trade surplus to swell. China’s exports relied less on processing trade this quarter, indicating exports contained more domestically produced value, though this shift likely reflects trade war conditions more than new structural improvements.

- Trade talks with the United States have shifted from escalating tensions to closing a “Phase 1” deal, but most of the commitments Beijing is talking about were in motion long before the trade war broke out. Policy news centered on expanding free trade zones (FTZs): these do not affect immediate trade and investment flows and are increasingly geared toward national strategic goals and regional integration.

This Quarter’s Numbers
(Missing data due to “technical problems,” according to China Customs, has plagued our primary indicator, the Composite Trade Liberalization Index [CTLI], for more than a year. While some of the missing data were updated retroactively, many gaps remain. Therefore, starting with this edition, we will use an alternative goods trade openness indicator and maintain the same services trade indicator.)

After a period of improvement in openness to goods imports from end-2016 to 3Q2018, imports for final consumption in China fell sharply relative to nominal GDP through 2Q2019. This is consistent with significant tariff liberalization that started in late 2015 and accelerated through 2018, and then the converse impact of tariff hikes on U.S. imports since late 2018. Services imports excluding tourism continued improving this year, though they still remain below 2013 levels.

The U.S.-China trade war has boosted China’s trade surplus, in conjunction with weaker domestic demand for certain imports amid slowing economic growth. China’s trade in both directions slowed in 2Q2019, but imports fell more than exports, pushing up the goods surplus to 3.5% of GDP compared with 3% the previous quarter (see External Trade). Less of what China imported was for reexport this quarter: processing imports relative to total exports fell to the lowest level since at least 2009 (see Structural Change in Goods Trade). That is typically the hallmark of a wealthier, less export-dependent country, but this quarter it is related to imports weakening more than exports.

Annualized, services imports and exports rose by their slowest pace in six quarters, to −5.8% year-on-year (yoy) and +0.3% yoy respectively in 2Q2019 from −5.6% and 5.1% in 1Q2019. With imports falling more than exports, the services deficit is narrowing modestly, from 2.1% relative to GDP last year to 1.9% this quarter. A significant fall in tourism abroad, and the related fall in transport services imports, drove an overall contraction. Payments for the use of intellectual property fell by 16% yoy in the first half of 2019, which is a negative signal for Services Trade Openness, even though imports of telecommunications, computer, and information services continued to rise.
Policy Analysis

Trade tensions between the United States and China reached an inflection point, from escalation in our Summer 2019 edition to a tariff escalation pause and purported work toward a Phase 1 agreement. On September 11, President Donald Trump delayed the escalation of tariffs to 30% on $250 billion in imports from China from October 1 to October 15 as a “gesture of good will” in recognition of the 70th anniversary of the founding of the People’s Republic of China. Negotiations continued in September, culminating in high-level meetings in Washington on October 10. The next day, Trump declared that Phase 1 of an agreement had been reached, though details were still to be worked out.

What little is known about Phase 1 suggests that most of Beijing’s concessions will be in line with pre-Trump trade conditions or policy changes China is pursuing.
unilaterally. The accord is reported to see China buying more U.S. agriculture products, with purchases to total $20 billion in year one after an agreement is concluded and $40–$50 billion per year in the second year. However, the $20 billion year-one commitment is $7 billion lower than pre-Trump highs or projected U.S. agriculture exports to China in 2020 under pre-trade war conditions, while $40–$50 billion per year seems difficult to reach given supply and demand conditions.

Other Phase 1 commitments are unconfirmed. Trump tweeted that China would buy $16–$20 billion in Boeing planes, grant market access to U.S. financial services firms, and step up intellectual property rights (IPR) protections. Beijing has already made plans to open the market to all foreign firms in a number of financial services sectors in 2020 (see Cross-Border Investment), while legal amendments in 1Q2019 addressed some egregious IPR protection issues (see Summer 2019 edition of Innovation). These commitments are meaningless unless they are enforced fairly, transparently, and reliably, and Beijing still has a long way to go. Some reports say China committed to disclosing official currency interventions, though most of that activity occurs outside official channels. In exchange, Trump agreed to delay the October 15 tariff escalation indefinitely, though a new round of tariffs on consumer goods imports from China is still set to take effect on December 15.

On October 25, U.S. and Chinese officials said they are “close to finalizing” some parts of an agreement without offering more details. President Xi Jinping and Trump were expected to meet and potentially sign an agreement at the mid-November Asia-Pacific Economic Cooperation (APEC) summit in Chile, after it was canceled in late October, both sides are now looking for another venue to sign the agreement. Efforts to strike a Phase 1 deal were further complicated in late November, as the U.S. Senate passed a bill in support of Hong Kong protesters; Beijing vowed to retaliate if President Trump signs the bill.

As the bilateral trade outlook remains uncertain, China is pursuing regional solutions to boost trade and support economic growth. On November 4, China and 14 other nations concluded the Regional Comprehensive Economic Partnership (RCEP), intended to reduce trade barriers and harmonize trade agreements between the Association of Southeast Asian Nations (ASEAN) and regional partners China, Japan, South Korea, Australia, and New Zealand. After seven years of negotiation, the pact is set to be signed in 2020.

In late August, the State Council announced the creation of six new free trade zones (FTZs), increasing the national total to 18 from 12, to help boost regional trade ties. China’s FTZs have consistently been met with skepticism but remain a key trade liberalization talking point. New FTZs in southwest provinces Guangxi and Yunnan are meant to close the growth gap with China’s coastal regions; boost trade with Myanmar, Laos, and Vietnam; and grow international trade via a new sea trade corridor coming in 2025. Industrial base Heilongjiang’s FTZ will help develop regional cooperation with Mongolia, Russia, and Northeast Asia.