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RHODIUM GROUP

China Dashboard Summer 2020 Update

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

Summer 2020 China Dashboard Net Assessment

China's economy was the first hit by COVID and the first to rebound. Reform proclamations issued in April and May by implication acknowledged that myriad past plans had never been accomplished, and that work to re-orient China to market-based systems remained to be done – urgently. The recovery seen today is not the result of marketization. Quite the opposite, it is the result of emergency government interventions which have buoyed activity in recent months but – by further placing the burden of public policy on ostensibly commercial or murky quasi-governmental balance sheets – have made it even harder to realize market allocation reform ambitions without risking a meltdown. Given the hostility leveled at the Communist Party of China from the United States, and China's superior economic performance amidst the pandemic, leaders in Beijing could be forgiven for thinking they had made the right call. But in the long-term picture, China's deferral of reform is not a response to international hostility but a cause of it, and today's economic expediency will make the net cost of righting China's policy foundations much greater tomorrow.

Winning the Battle, but Not the War

As we go into the autumn of 2020, the outlook for China's economy is more important than ever. The prognosis for recovery from the COVID-19 recession is crucial: even before the pandemic, China accounted for more global growth than the United States, Europe and Japan combined (Table 1), and with the rest of the world in various stages of lock down, it is the *only* place reporting positive year-on-year (yoy) activity. But just as important as the quantity of China's growth is the question of what is fueling it: reform or statism? Because a statist recovery, if it displaces and delays important policy reform, will sacrifice China's future growth and will further provoke a protective backlash from the liberal market world. Consider the quantity and quality dimensions of China's economic recovery.

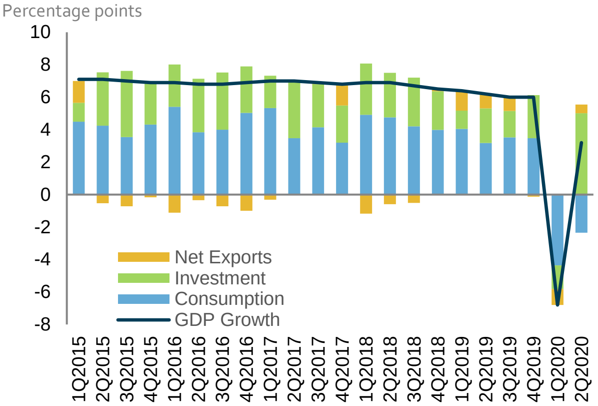
Table 1: GDP Growth Comparisons: Share of 2019 Global Growth, and Country-level 2Q2020 GDP Growth

	Share of 2019 Global GDP Growth*	2Q2020 Real GDP Growth*
China	35.0%	3.2%
United States	12.7%	-9.5%
EU	8.8%	-14.2%
France	1.2%	-19.0%
Germany	0.7%	-11.7%
UK	1.2%	-21.7%
Japan	0.9%	-10.0%
Canada	0.8%	-13.5%

Source: OECD, World Bank.
*Share of 2019 global GDP growth calculated based on 2017 purchasing power parities (PPP), which account for cross-currency differences in price levels to make GDP comparable across economies. 2Q2020 GDP growth is preliminary.

As of this writing, we have official data part way into the third quarter, through July 2020. China's recovery has been uneven and driven mainly by government-juiced infrastructure and property construction. Figure 1 shows the extent of that imbalance: investment contributed 5% to China's Q2 GDP growth of 3.2% yoy, while consumption subtracted 2.3%. Net exports also contributed positively to growth, as foreign consumer need for products from China – especially medical supplies and equipment – remained strong while domestic demand remained unrecovered. Weak household consumption was evident in the 1.1% yoy decline in headline retail sales in July. This imbalance points to slower growth in the second half of the year, though from this low baseline and thanks to good virus control, China's consumption will continue to gradually pep back up.

Figure 1: Reported Real GDP Growth, Contribution by Expenditure Component



Source: National Bureau of Statistics.

The bottom line is that China has achieved a partial recovery from the COVID-19 recession. The sharpest uptick was seen in June as pent up demand from five months of closure was released, quickly tailing off starting in July. China's positive numbers were made possible by diligent lockdowns to break virus transmission in 1Q2020, and massive testing to contain new outbreaks, allowing growth-promotion policies to do their work. Debt burdens still mounting from past stimulus made it impossible to restore 6%+ growth this year, but the 1-2% full-year outcome Beijing is now tracking would be the world's most impressive in this catastrophic year.

However, there is a problem with this strong showing. Unlike the advanced market economies, China is years behind on long-term structural economic policy reforms essential to future growth and stability. Everyone needs statism to steer through a pandemic; efficient markets remain crucial, and too distant, thereafter.

Beijing announced reforms in April and May that tacitly acknowledge that decades of past effort to instill market economy systems have failed to succeed. On April 9, 2020, the Communist Party and State Council jointly released Guidance on making market mechanisms more important. On May 18, a more comprehensive reform decree ("Guidance on Speeding Up the Improvement of the Socialist Market Economic System in the New Era") was issued by the Party Central Committee and the State Council. The long list of critical reforms identified in this plan is similar to the 2013 Third Plenum Decisions plan. It other words, the promised 2013–2020 reform did not happen, as this Dashboard has been noting. The May guidance stressed employment priorities, the limits of monetary and fiscal policy for sustaining growth, and a host of reforms to the marketplace needed to staunch an exodus of private and foreign firms. These included greater sanctity for private business property, improved IP and trade secrets protection, serious reduction of informal, illegal but common market entry barriers, and better competition review mechanisms.

Current Chinese policy essentially validates the conclusions we have drawn in China Dashboard since our inaugural publication in mid-2017: reform work has not progressed sufficiently to date, and has even regressed in important areas.

Dashboard Indicators

Our current period (1Q2020) Dashboard indicators and observations on present policy dynamics reinforce this story.

The announcements in April and May rekindled expectations for policy change, but so far implementation has only proceeded in limited policy areas. For example, in land reform two provinces are trialing rural land use transfers, consistent with the April/May guidance to make land use more market-driven. Nevertheless, that is just a limited experiment, and the basic problem built up over decades – that local authorities drag their feet on reform because they need illiberal land conditions to help them raise revenues – remains. Flexible rural property-use transfers are being piloted in limited areas but are years from widespread implementation.

More germane to the question of whether China is serious about adjusting the way its system works, and its implications for other nations, is the case of innovation policy. Innovation is one of two areas where we have reported progress since 2013, and in the recent period we saw a slew of commitments and plans, and even some encouraging admissions that too much emphasis is put on the number of patents in China instead of quality. But consider how radically the world is changing in this area. The United States is ratcheting up restrictions on high technology commerce with China and urging third countries to disrupt their engagement with Chinese production chains in telecommunications and to exclude Chinese vendors, on national security grounds. That is just one front in an expanding innovation showdown that is stretching beyond the United States. By ponderously including data as a new factor of production to be allocated by a yet to be explained new Chinese government mechanism, the April/May reform guidance raises more questions than answers. This is a classic case where Chinese policy response seems significant compared to past practice, but is in fact very modest when gauged against current international circumstances.

The April and May policy pledges did not offer new fiscal and financial policy goals—most objectives, such as "clarifying local/central fiscal responsibilities" and "establishing a modern central bank system"—are the same as stated in 2013. The most important actions in finance this year have been continued clean up of shadow banking and tighter controls on speculative investment. But in response to COVID-19, banks were instructed to extend loans and prevent defaults, even as bank runs and solvency issues mounted. In the fiscal space, Beijing has resorted to the same fiscal stimulus approach as in recessions past by channeling money to fund infrastructure construction. Those moves can certainly be credited with buoying infrastructure activity, which has been the workhorses of the present recovery. But they have nothing to do with making the market more central in capital allocation. And in fact, by further saddling banks, local government finance vehicles, and struggling firms with additional debt incurred in lieu of proper public sector financing of support, they will make the wholesale financial system reform China requires that much more difficult.

The View from Abroad: China Is Turning Inward

At a mid-year meeting on the economy, the Politburo Standing Committee announced a policy encouraging exporters to turn inwards. Policy rhetoric around a shift to "internal circulation" has picked up in 2020, and at the May 14 Politburo meeting was described as taking advantage of China's "enormous" domestic market and demand as a new source of growth. The strategy says China's manufacturing sector must focus more on serving the domestic market and securing critical technology supply chains. There are three ways to interpret this. First, it could be argued that the rest of the world economy is in serious trouble, and Beijing is preparing its firms and workers for that by steering them to the only market still growing – the home market. Second, this could be seen to reveal China's expectation that it has no chance of satisfying foreign demand for economic reform, market access, political liberalization and security pacifism, and so a backlash is inevitable and China must prepare for that. The third explanation for an inward turn is that leaders realize that it is reasonable and overdue that they ramp up domestic consumption instead of relying on foreign demand. If that is the case, Beijing is conceding to long-standing U.S. and other advanced economy demands for a more balanced trade picture, but is couching the change in nationalistic terms rather than appear pliant.

Whichever of these hypotheses best explains China's thinking, the underlying reality is that a trend toward less international engagement will persist for some time to come. If China does seriously attempt reform (whether admitting it or not), the same impediment remains which prevented movement 2012-2020: stability trumps market efficiency. Fears of crisis prevent bold action. Political insecurity precludes open discussion and adaptation, as ideological loyalty to the Party's unimpeachable judgement is treated as paramount.

A shift to internal circulation would not necessarily mean closing domestic markets to the world. It could result in shift toward increasing consumption without more protectionism but requires first raising household incomes. But that change likely remains distant given Beijing's track record on Dashboard indicators. In the meantime, by propping up domestic production while other countries remain in recession, China risks another buildup of overcapacity.

In the short-term China's statist turn has helped achieve an unbalanced but enviable recovery. But problems are certain to erupt. In fact, they already are, internally. After the failure of Baoshang Bank last year—the first bank default since 1998—China has experienced a slow-motion banking crisis, as new companies and types of assets default, raising questions about government guarantees. Unemployment and labor market conditions have not created a firestorm for the Party yet, but the risk of popular ire is growing.

Conclusion

The Dashboard was born in the hope that China would prioritize convergence with liberal economic norms, and when it did so that would be observed abroad in a timely manner so that an international consensus about mutual interdependence could be achieved. At a time of profound systemic dilemmas around the world, our indicators do present a conclusion, and it is consistent with China's own policy pronouncements: China has not implemented reform in recent years, and under the flag of COVID-19 is further deferring market liberalization even while talking about the importance of market allocation efficiency. This reality is driving the systemic rivalry with market democracies and will likely do so for some years to come regardless of electoral outcomes in any given nation.

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

- We downgrade our assessment of competition policy reform from neutral to negative for the first quarter of 2020 because authorities disproportionately scrutinized foreign mergers, and the domestic business environment deteriorated.

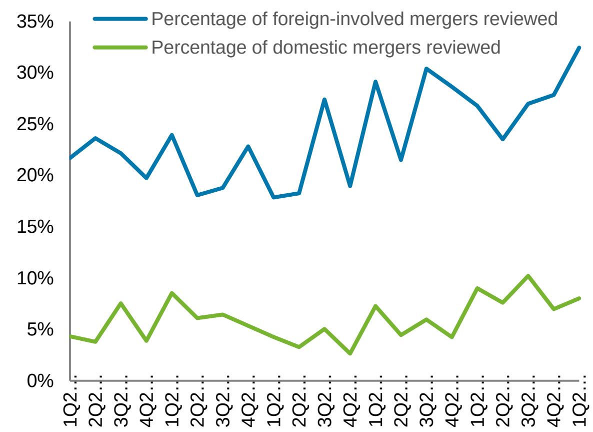
- The share of mergers involving foreign firms that came under review surged to 32% in 1Q2020, the highest in at least five years. New company registrations decreased, while the pricing power of large listed companies increased at the expense of smaller companies.

- Beijing promised improvements in the competitive environment in China, this time with a focus on the judicial system, but did not offer a timeline for action.

This Quarter's Numbers

China's competition environment deteriorated in 1Q2020 as authorities disproportionally targeted foreign firms in their merger reviews. The State Administration of Market Regulation (SAMR) reviewed 49 foreign-involved mergers, 4 fewer than in 4Q2019. By contrast, only 26 domestic-only mergers were reviewed, 23 fewer than in 4Q2019. The pandemic reduced foreign-involved deals by 17% year-on-year (yoy) to 151, and domestic deals by only 9% yoy to 324. As a result, the share of foreign-involved deals that were subject to scrutiny increased to 32% from 28% in the prior quarter, the highest level on record. In contrast, fewer than 10% of domestic deals were subject to review.

Primary Indicator: Merger Reviews
Percentage



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

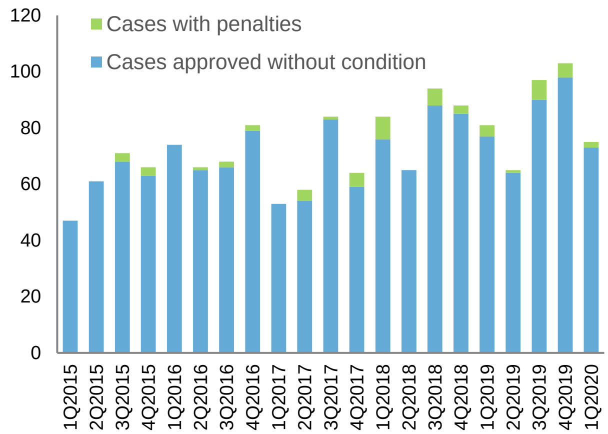
The COVID-19 pandemic affected China's judicial transparency as numerous government offices shut down. In 1Q2020, the Supreme Court published 15,904 new competition-related cases on its website, 32% fewer than in 4Q2019.

The pandemic also affected reporting on competition data. Instead of releasing market entry data as usual, SAMR informed the press in July that "on average around 20,000 new companies were registered per day in 1H2020," suggesting that China's business environment had not changed since last year, when registrations were at the same level. Third-party data, by contrast, showed that new company registrations plunged to an average of 18,300 per day between February and April, slightly lower than in the past year.

Despite the weak business environment, listed company pricing power increased in 1Q2020. Notably, the pricing power of listed private companies in China reached the OECD level for the first time. The improvement was likely caused by a sharper reduction in costs than an increase in revenues during the pandemic. This phenomenon suggests that these companies, which are usually larger in size and more powerful than others in the market, either exploited lower prices from their vendors or reduced investments in the period. Neither is a good sign for the business environment.

Supplemental 1: Results of Merger Reviews

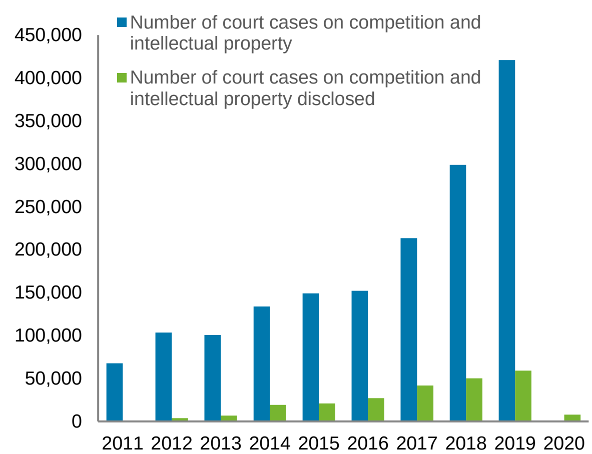
Number of cases



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

Supplemental 2: Judicial System Transparency

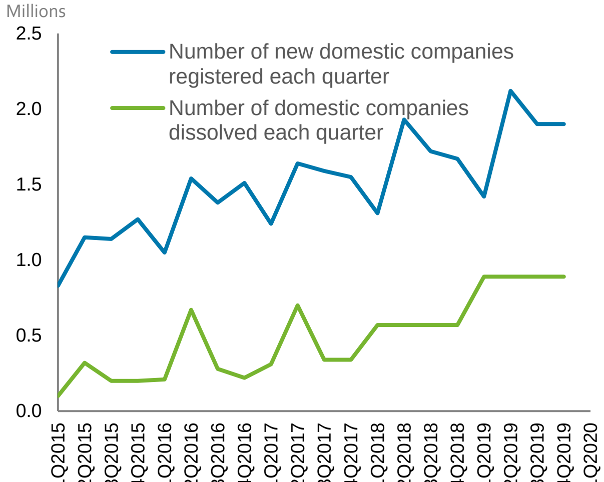
Number of court cases



Source: Judgements Online, Supreme Court.

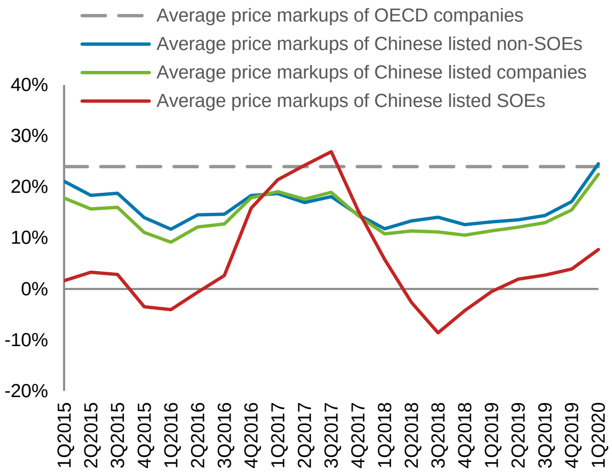
Supplemental 3: Market Entry and Exit

Millions



Source: State Administration for Market Regulation, Rhodium Group.

Supplemental 4: Pricing Power Index
Percentage



Source: Bloomberg, Rhodium Group.

Policy Analysis
Beijing made new reform pledges in the first half of 2020. On May 18, authorities released a document ("Guidance on Speeding Up the Improvement of the Socialist Market Economic System in the New Era") that pledged to deepen economic reform with a focus on "strengthening protection of property rights and improving market allocation of resources." It defined a "high-standard market mechanism" as one that provides effective incentives through property rights, facilitates the free flow of production factors, allows flexible price adjustments, promotes fair and orderly competition, and enables efficient companies to grow and inefficient ones to exit. It dedicated an entire section to explaining how it will use the judicial system to pursue these goals.

On July 22, the Supreme Court and the National Development and Reform Commission released an opinion on how to provide such judicial services. The opinion detailed the role of the judiciary in each step of market competition, including treatment of firms of different ownership, protection of property rights, contracts and dispute resolution, regulation and administration, social justice and fairness, and the handling of foreign-related disputes. The opinion specifically promises to (1) repeal regulations that distinguish market players by ownership and that treat private firms unequally, (2) discipline the government from infringing (e.g., illegally seizing or freezing) private property rights, and (3) strengthen privacy protections.

These promises will take time to implement. The opinion itself did not specify any targets or timeline, and it contained so much detail that implementation would require significant adjustments and interministerial coordination beyond the judicial system. For example, "repealing regulations that distinguish market players by ownership" would require abolishing the newly passed Foreign Investment Law as well as the Law of State-owned Assets in Enterprises. Neither can be done in the near term. Promised steps to prevent the government from infringing on private property rights would require more checks and balances. For now, these statements are not convincing to private investors.

In addition to improving the judicial system, Beijing also committed to improving the business environment. On July 21, the State Council released an opinion that promises to (1) streamline administrative procedures for investment, production, trade, and employment and (2) improve the quality and efficiency of government services such as tax administration and trademark registration, among other measures. This opinion is not a concrete policy change, but it is an additional signal that authorities see a need to prioritize market mechanisms.

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

- Our assessment of cross-border investment liberalization remains unchanged at slightly negative for 1Q2020. The primary indicator improved, but only because the economy shrank more than capital inflows under COVID-19.

- Both foreign direct investment and portfolio inflows decreased considerably in 1Q2020 due to the COVID-19 shock. However, a global U.S. dollar funding squeeze likely caused Chinese authorities to sell USD assets, which led to net capital inflows in the quarter—a reversal of the previous trend. This change is likely to be temporary.

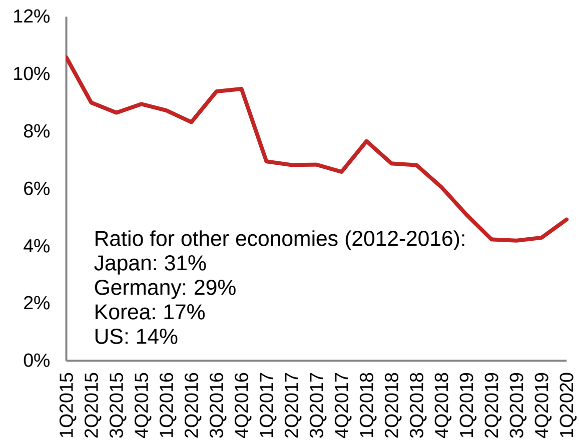
- Beijing doubled down on its efforts to encourage foreign investors to stay in China by reducing restrictions and acknowledging the need to end unequal treatment.

This Quarter's Numbers

The ratio of two-way capital flows to GDP increased to 4.93% in 1Q2020, up from 4.29% in 4Q2019, the biggest quarter-over-quarter improvement in our primary indicator in two years (see **External Financial Liberalization**). But the reason for the increase is that GDP contracted more than capital flows in the period. The reading remains significantly lower than the 9% registered by China in 2014, and far below the levels seen in advanced economies like the United States (14%), Germany (29%), and Japan (31%).

Primary Indicator: External Financial Liberalization

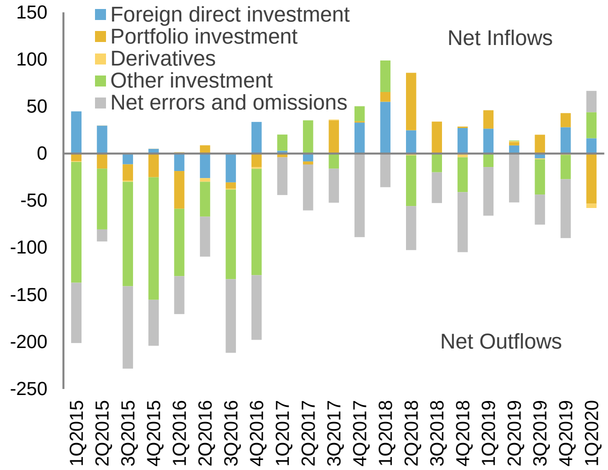
Gross sum of cross-border investment flows under China's financial account (excluding reserves) as a share of GDP, year to date, percent



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

Supplemental 1: Net Capital Flows

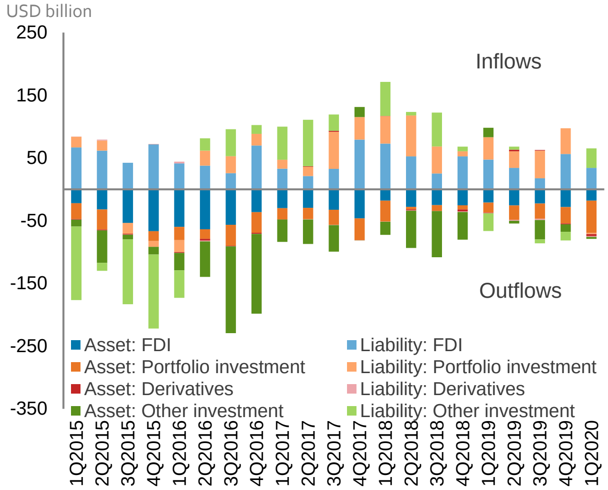
USD billion



Source: State Administration of Foreign Exchange.

Supplemental 2: Breakdown of Cross-Border Financial Flows

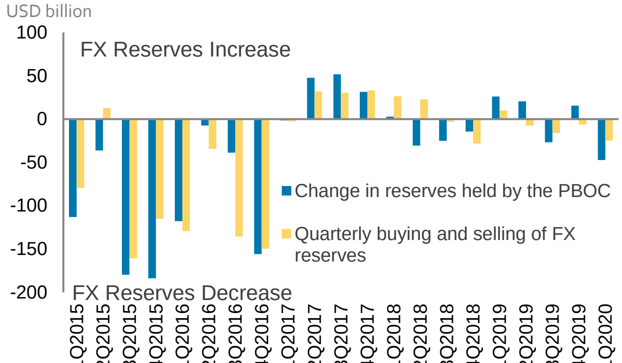
USD billion



Source: State Administration of Foreign Exchange.

Supplemental 3: Currency Intervention

USD billion



Source: State Administration of Foreign Exchange, Rhodium Group.

Supplemental 4: Foreign Appetite and Market Access

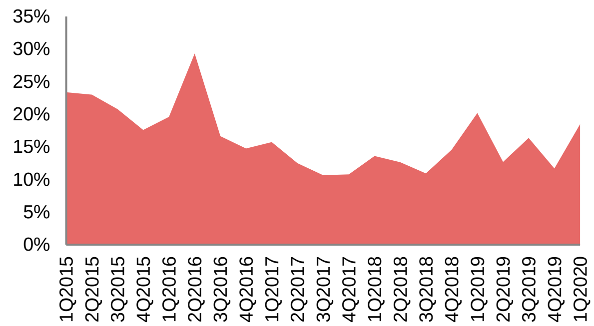
The COVID-19 crisis triggered a surprising shift in the net capital flows balance for the first time in six years: inflows instead of outflows in 1Q2020 (see **Net Capital Flows**). Global U.S. dollar market movements were responsible for this. As banks and companies hoarded dollars to repay debts and keep business going during the pandemic, high demand created a global dollar funding squeeze. In response, Beijing's State Administration of Foreign Exchange (SAFE) and many state-owned enterprises (SOEs) appear to have repatriated foreign capital to meet dollar-funding demand from domestic borrowers.

These machinations effected exchange rate pressures: China's central bank intervened to slow the yuan's decline in March and to moderate its subsequent appreciation in June. As a result, China's foreign exchange reserves saw the largest single-quarter decline since 3Q2017, falling $47.3 billion in 1Q2020 (see **FX Reserves**). Since the COVID-19 pandemic began, the central bank has managed the currency more directly against the U.S. dollar, as opposed to a basket of currencies, which is a step backward for exchange rate flexibility.

Despite much discussion about reducing dependence on the U.S. dollar, renminbi (RMB) internationalization increased only slightly. RMB-denominated global payments accounted for 1.87% of global transactions by value in 1Q2020, up from 1.84% in 4Q2019, a trivial increase (see **Globalization of China's Currency**). The RMB remained the fifth most active currency in international payments as of March 2020.

The share of foreign participation in China's domestic mergers and acquisition (M&A) activities increased to 18% from 12% (see **Foreign Appetite and Market Access**). The number of foreign-involved transactions was on par with typical first quarter levels, but the total number of transactions decreased considerably, resulting in a rising share for foreign-involved deals.

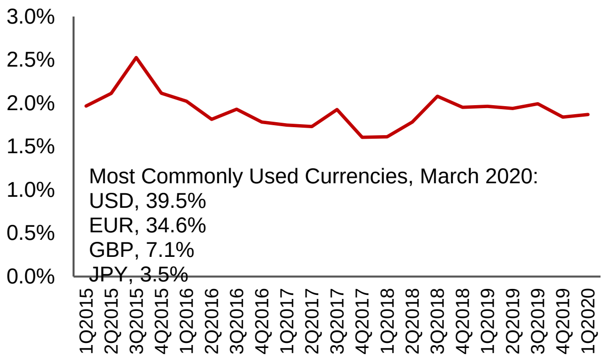
Share of deals with foreign buyers in total number of acquisitions with Chinese target, percentage



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

Supplemental 5: Globalization of China's Currency

Chinese yuan (RMB) usage in global transactions, percent



Source: SWIFT.

Policy Analysis

The COVID-19 pandemic has pushed foreign firms and governments to reconsider their future with China. Foreign investment has long played a crucial role in China's economy; in the first half of 2020, Beijing took steps to encourage foreign investors to stay rather than hedge their China bets. Those foreign firms are canaries in the Chinese coal mine. Beijing needs the world to see them thriving, and to see RMB internationalization moving forward to prove that sanctioning China over its authoritarian crackdown in Hong Kong, Xinjiang, and elsewhere will not stymie its rise, and that China's dependence on the U.S. dollar system does not constrain it.

To make a case for China's inexorable globalization, Beijing took other steps as well. On May 7, authorities lifted quota limits on foreign portfolio investment through the Qualified Foreign Institutional Investors (QFII) and RMB Qualified Foreign Institutional Investors (RQFII) programs. Ending these limits was intended to promote foreign investor inflows, but COVID-19 interrupted that. Foreign investors did not view China as a safe haven during the crisis and needed to liquidate securities quickly, producing a significant net outflow (USD 53.2 billion) under China's portfolio securities account—the largest in this component in history. Inflows returned in 2Q2020, offsetting much of the first quarter outflow, but the outlook is murky.

On June 26, the National Development and Reform Commission (NDRC) and the Ministry of Commerce released the updated "Special Administrative Measures on Access to Foreign Investment," which reduced the number of restricted industries to 33 from 40. Most of the changes had been flagged beforehand. These included a reduction in foreign ownership restrictions in the securities, investment fund management, futures, and life insurance sectors, as well as a lifting of the foreign ownership cap in commercial vehicle manufacturing.

A July 29 State Council Executive meeting reemphasized the importance of stabilizing foreign investment. The State Council stressed the importance of ensuring equal financing support for foreign-invested companies, including refinancing and new loans from the Import-Export Bank. Similar language on eliminating unequal treatment for foreign firms can be found in the July 12 State Council "Guidance on Stabilizing Foreign Trade and Investment." This included a pledge to facilitate travel for "qualified foreign business executives," suggesting that the government is keen to have foreign companies resume normal operations even as COVID-19 restrictions remain in place.

Continued U.S. monetary easing has drawn criticism from Beijing about the long-term stability of the dollar and valuation of dollar-denominated assets. Fang Xinghai, vice chairman of the China Securities Regulatory Commission (CSRC), argued in June that China would need to accelerate RMB internationalization to reduce its exposure to valuation risks from USD-denominated assets. Fang also implied that rising political tensions between China and the United States have made China's dependence on the USD payment system a security risk.

China will not be able to significantly increase the offshore use of its currency in the short term. As noted above, RMB usage is far lower that of other international currencies, and there has been limited action to promote it in 2020. China's persistent trade surpluses limit the RMB's overseas circulation, and capital outflows remain subject to regulatory controls. Recent rhetoric highlighting the need for RMB internationalization is likely a response to the threat of sanctions from the United States, related to Hong Kong and Xinjiang, rather than a sign that China is setting new policy priorities.

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

For the air pollution index, a range of factors drives seasonal concentrations of PM 2.5; one of the largest is the domestic use of coal for heating and cooking. We source monthly average PM 2.5 data from the China National Environmental Monitoring Center (CNEMC) for 74 Chinese cities. From these data, we remove some of these seasonal effects using a decomposition analysis. We then average the data across the 74 cities to produce our index. Previously, we utilized daily U.S. State Department air quality data from five environmental monitoring stations at U.S. consulates in China. Due to both the retirement of the U.S. State Department's air quality feeds and increased reliability of China's own air quality data, we implemented a switch to CNEMC data for our analysis starting in 3Q2019.

For the water quality index, we use data from the Ministry of Environment and Ecology (MEE). Specifically, we track the average water quality for the Yangtze, Yellow, Pearl, Songhua, Huai, Hai, Liao, and Zhejiang-Fujian river basins. The average water quality from these basins is aggregated into a national indicator. The MEE publishes water quality data on a monthly basis derived from several hundred monitoring stations across the country in key watersheds. Based on 21 indicators, including total nitrogen, pH, dissolved oxygen, heavy metals, chemical oxygen demand, and others (all based on Surface Water Environmental Quality Standard: GB3838-22), these surface water bodies are put into categories ranging from I (excellent, drinking quality) to V+ (high pollution, not suitable for any use). By tracking the changes in these categories over time, our water quality index can provide an idea of the overall health of Chinese surface water supplies. As seasonal effects can change water quality, we seasonally adjust this index as well. In January 2017, the Ministry of Environmental Protection (MEP, now MEE) started issuing weekly quality reports. We rely on these data for December 2016 through June 2018.

We rebase the air quality data to November 2014 as the benchmark to track quarter-on-quarter changes. Water pollution data only go back to October 2012. We also adjusted the World Health Organization standards to provide a comparable context.

Quarterly Assessment and Outlook

- Our environmental policy reform assessment remains unchanged for 1Q2020. Air pollution in China dropped to record lows as a result of China's response to COVID-19, but these effects were temporary.

- COVID-19 affected every one of our indicators: the share of renewable power increased as coal plants were temporarily taken offline amid reduced demand, while new energy vehicle sales plummeted due to a broader consumption downturn.

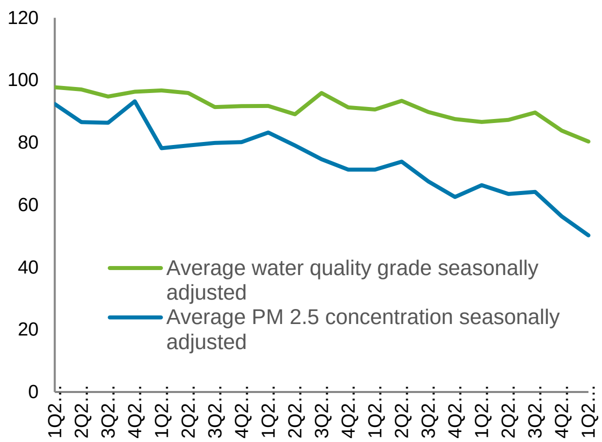
- As the COVID-19 crisis begins to subside, authorities in Beijing are struggling to strike a balance between kick-starting growth and meeting environmental targets.

This Quarter's Numbers

As China's economy shut down in response to COVID-19, air pollution plummeted to the lowest levels in our records (see **Environmental Impacts**). Average PM 2.5 pollution levels fell to 30 micrograms per square meter in 1Q2020. This is the closest China has come to meeting the World Health Organization's recommended air quality standard of 25 micrograms per square meter.

Primary Indicator: Water and Air Quality Trends

Index, Nov 2014 = 100



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

However, the first-quarter reduction in air pollution was a temporary phenomenon tied to pandemic-related lockdowns rather than reform. In January, the last month before the lockdowns, pollution levels in every northern Chinese province were worse than the previous year. Tellingly, pollution levels have risen rapidly since April, when the lockdowns were eased.

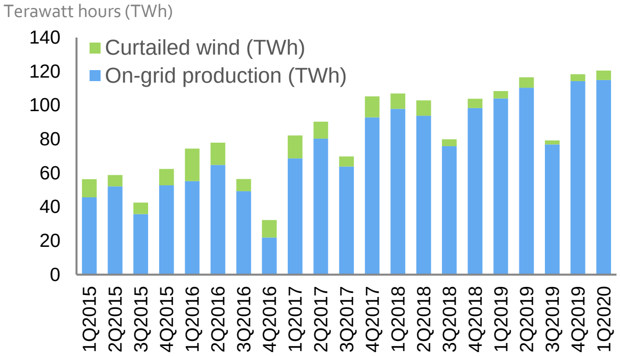
Water quality also improved modestly during the COVID-19 crisis, with six of the eight river systems we track showing improvements. Unlike the air quality data, water quality improvements better reflect the impact of environmental reform policies. These include water pollution enforcement in the Yangtze and Pearl Basins under the "Water Ten" plan from 2015 and other region-specific measures.

As COVID-related lockdowns led to better environmental conditions in the short term, they also disrupted Beijing's long-term plans to transition China's auto fleet toward environmentally friendly electric vehicles. COVID-19 ravaged China's auto market in 1Q2020, with the sales of **New Energy Vehicles (NEVs)** dropping 62% year-on-year (yoy), and accounting for only 3% of all auto sales. This is the sharpest drop in our dataset. Lockdowns limited in-person sales and production, while consumers deferred big purchases. Accordingly, in January, Beijing delayed plans to phase out NEV purchase subsidies that were set to expire this year, extending them to 2022. Although this may buoy sales in the short term, it also undermines China's goal of consolidating the NEV market and building a self-sufficient industry that can make up 25% of all auto sales by 2025.

The amount of wind energy that was wasted because it could not be transmitted to the grid increased slightly in 1Q2020 (see **Wind Energy Curtailment**). COVID-19 had an impact here as well: wind turbines continued to spin during the crisis; however, as lockdowns and a broader economic downturn reduced energy consumption, the amount of power that was actually needed by the grid declined. This increased the percentage of wasted electricity. Policymakers must develop interprovincial grids to reduce power costs and ensure that new capacity is not wasted.

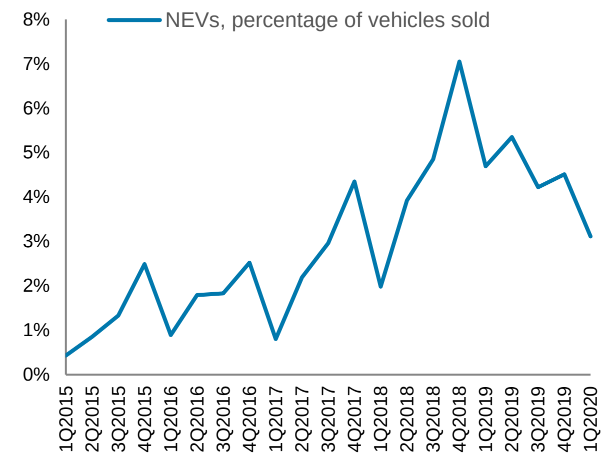
Supplemental 1: Wind Energy Curtailment

Terawatt hours (TWh)



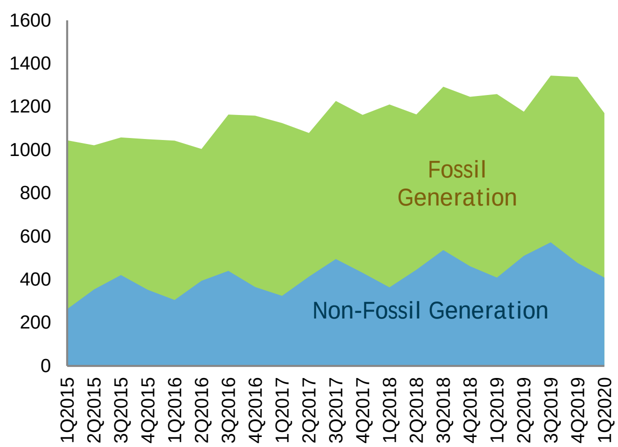
Source: China Electricity Council, Rhodium Group.

Supplemental 2: Sale of New Energy Vehicles
Percent



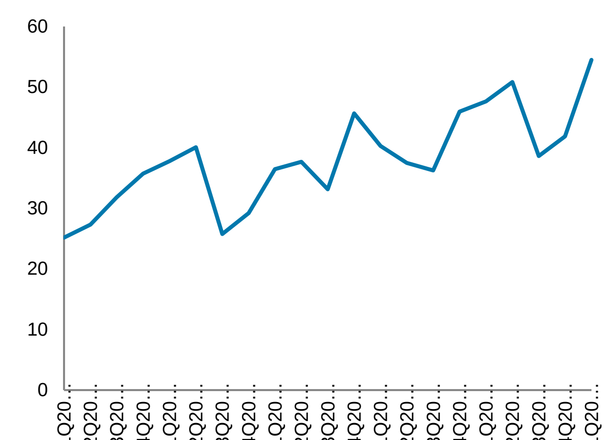
Source: China Association of Automobile Manufacturers, Rhodium Group.

Supplemental 3: Overall Electricity Generation
Billion Kilowatt-Hours



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

Supplemental 4: Non-Fossil Electricity Generation
Index



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

Policy Analysis

In the wake of the COVID-19 crisis, officials are under pressure to deliver growth and are therefore reassessing their environmental plans for 2020. These plans foresaw a phasing out of subsidies for new energy and green industries (like NEVs and renewables). They also placed limits on new polluting projects, particularly in industries suffering from overcapacity, like coal and steel. Unfortunately, a sharp economic contraction in the first quarter and a challenging growth outlook for the rest of the year have shifted priorities, with provincial officials pushing hard to support local industries. Early indications suggest that this will lead to a relaxation of environmental restrictions.

Provinces have pushed forward new coal projects in 2020 to stimulate local economies. Between January and June 2020, China's provinces approved more new coal capacity than in the years 2018 and 2019 combined, threatening to exacerbate overcapacity and air pollution problems. On June 18, the National Development and Reform Commission (NDRC) pushed back by issuing guidelines that affirm the need to limit construction of new coal power plants and instruct all provinces to look to renewables or energy imports from other provinces before approving new coal projects. However, it is uncertain how effective these guidelines will be. Under China's "traffic light" system, most of the country (25 of 31 provinces) can develop new coal plants with no or minimal restrictions. Provinces still control the coal approval process and are therefore likely to continue to increase coal capacity in 2020, threatening air pollution goals.

While attempts are being made to clarify responsibilities for environmental policy enforcement, this may end up undermining enforcement consistency between regions. On June 13, China's State Council issued rules formally splitting environmental protection duties (and costs) between the central and local governments. Under the new rules, the central government has responsibility for developing national environmental plans and handling cross-province policies, while local governments are on the hook to fund, monitor, and enforce environmental laws in their jurisdictions. This could hurt nationwide monitoring and enforcement if cash-strapped local governments, which are already turning a blind eye to polluting local industries, lack the funds to carry out their duties

Financial System

The Story So Far

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

- Regarding interest rate liberalization, Beijing removed a floor on lending rates in July 2013. In 2015, Beijing gradually increased the ceilings that banks could offer on deposit rates and then removed them entirely in October 2015. While formal constraints have been lifted, banks continue to limit full market pricing of deposits, reportedly because of informal guidance from regulators.

- Exchange rate liberalization has progressed along a rocky path, as there is still considerable evidence of People's Bank of China (PBOC) intervention in the foreign exchange markets. After a poorly communicated adjustment to the currency's daily fixing mechanism produced a shock depreciation in August 2015, RMB movements have become much more volatile. While markets have a freer hand to adjust the RMB's value, the central bank's intervention is also persistent, reducing benefits of market determination.

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

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

Methodology

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

Quarterly Assessment and Outlook

- We downgrade our financial reform assessment from positive to negative for 1Q2020. China has leveraged its financial system to combat the COVID-19 crisis, urging banks to extend loans and prevent defaults. This is negative for financial reform and efficiency, even if necessary as a temporary measure to kick-start growth.

- Our primary indicator showed a sharp decline in financial efficiency as new credit to the economy rose while first quarter GDP fell by 6.8% year-on-year (yoy). These trends will reverse in 2Q2020 because growth has rebounded.

- Regulators continued to pressure shadow banking institutions, even after defaults at trust companies and smaller banks, and cracked down on speculation in financial markets.

This Quarter's Numbers

Our primary indicator, the **Quarterly Incremental Capital Output Ratio** (QuICOR), rose rapidly in 1Q2020, indicating that China's financial system got worse at pricing capital and risk efficiently. As activity shut down under COVID-19, China's banks deployed financial resources aggressively to prevent an even sharper growth contraction and avoid more defaults and bankruptcies. Because negative GDP growth causes our primary indicator to give a faulty reading, we adjusted the QuICOR by using an assumption of zero GDP growth in the first quarter. The revised primary indicator rose from 7.36 in 4Q2019 to 7.51 in 1Q2020, which understates the actual rise in financial system inefficiency.

Primary Indicator: Incremental Capital Output Ratio

4qma, ratio value

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

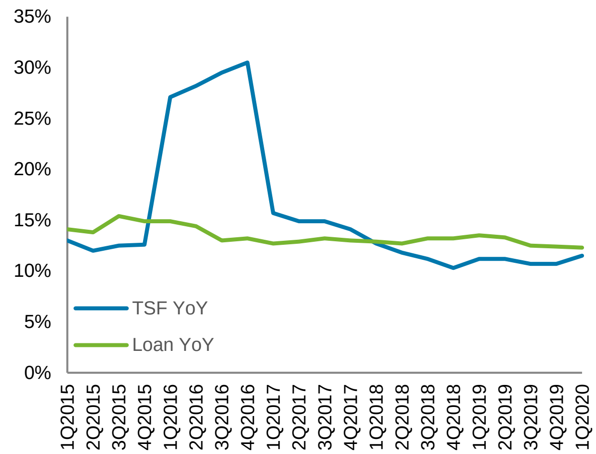
Falling returns on new capital are a setback to financial reform, especially if China's banks continue to roll over loans and extend forbearance through 2020 and into 2021. Doing so creates nonperforming asset problems, which banks are left to deal with on their own. Watch for this in the second half of 2020.

While **Growth in Credit** picked up slightly from 10.7% to 11.5% in 1Q2020, shadow banking continued to contract, due to tighter regulations, particularly targeting trust companies. Regulators are focused on reducing financial risks despite the slowdown in the economy and are trying to boost official credit, while also adding new regulations to keep informal shadow financing in check. To ease financial system pressure and help institutions manage funding costs, the central bank has guided short-term interest rates lower. Funding rates for nonbank institutions fell to a 1Q2020 average of 2.26% from 2.65% in 4Q2019, and bank financing rates fell sharply to 2.11% from 2.50% (see **Interbank Lending Rates**).

Foreign institutional investors moved money out of China during the COVID-19 outbreak: China's financial markets were not viewed as a safe haven. However, this had a greater impact on the equity market than the bond market, as the share of foreign holdings in China's bond market remained unchanged at 2.2% in 1Q2020 (see **Foreign Held Bonds**), a low level compared with that in advanced economies.

Supplemental 1: Growth in Credit

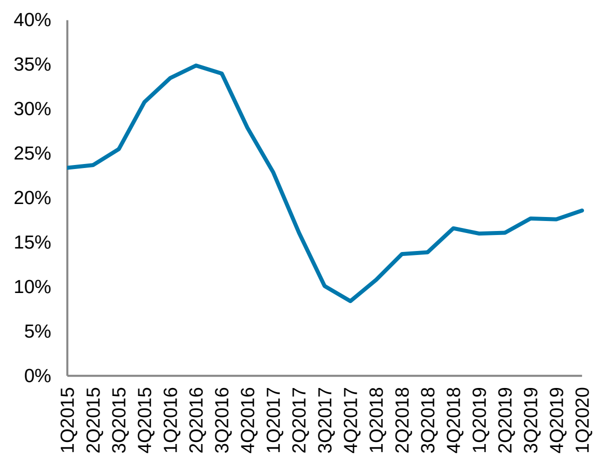
Percent



Source: People's Bank of China.

Supplemental 2: Direct Financing Ratio

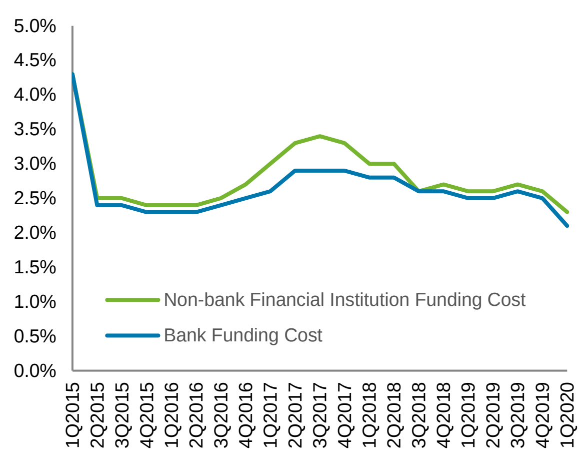
4qma, percent



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

Supplemental 3: Interbank Lending Rates

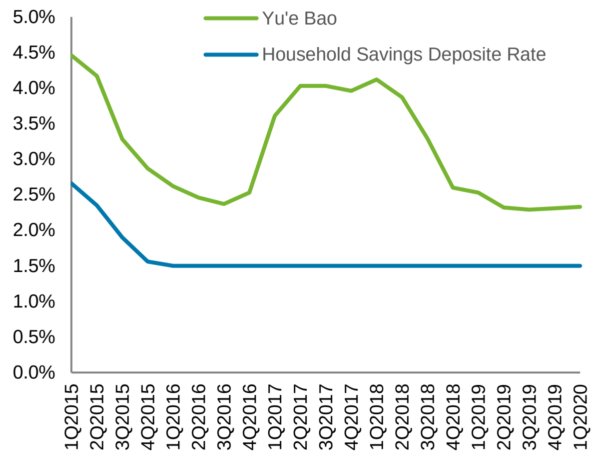
Quarterly average, percent



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

Supplemental 4: Return on Savings

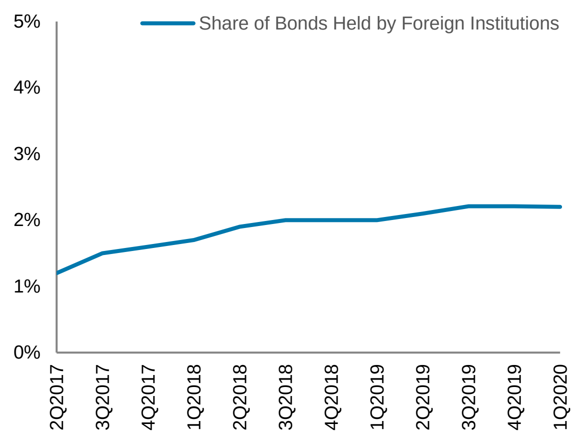
Quarterly average, percent



Source: People's Bank of China.

Supplemental 5: Foreign Held Bonds

Quarterly average, percent



Source: ChinaBond, Shanghai Clearing House, Rhodium Group.

Policy Analysis

Some emergency expansion in credit was inevitable as a response to the COVID-19 outbreak and its economic consequences. As such, financial reform intentions and policy signals will be hard to interpret this year.

One risk to financial reform is that banks will be too lenient with firms struggling to repay debt. Highly indebted firms were already saddled with nonperforming loans, and in some cases defaulting, even before the COVID-19 outbreak. The crisis is now being blamed for debt problems that in fact were building up for years. Banks can only do so much in extending new loans to zombie companies—they are already short of capital and their balance sheets are stretched. Authorities have guided banks to extend forbearance for distressed borrowers until March 2021, but this appears to be too long given that China's economy returned to growth in 2Q2020. Should this guidance continue or be extended, it will be a profoundly negative signal for financial reform.

On the positive side, authorities continue to make some effort to clean up speculative financial activities and shadow banking channels. When short-term funding rates fell in March and April, some firms found an easy arbitrage opportunity by borrowing at those lower rates and offering money at higher rates through other channels. After a concerted regulatory effort and a slight rise in short-term money market rates in May and June, those arbitrage opportunities have declined in 2Q2020, which should reduce speculation to some extent.

China's shadow banking sector is showing new signs of trouble, with several trust companies facing protests from angry investors frustrated with losses from defaulted products. Rather than cave into these investors, Chinese authorities have tightened regulations to restrict trust firms from issuing new products. The result has been a slowdown in shadow credit in 2Q2020, consistent with efforts to control illicit financing. At the same time, frustrated investors who saw new risks emerging in China's shadow banking system chose to redirect funds into the equity market, potentially starting a new bubble.

On balance, financial reform has been heading in the wrong direction since the COVID-19 outbreak as banks faced pressure to ignore the usual credit risks in making loans. Investors are now starting to see the prospect of losses in more asset categories, a positive step toward removing implicit guarantees in China's financial system. The greatest risk to the limited financial reform progress we have seen so far is a prolonged relaxation of regulations and lending criteria to respond to the economic disruption of COVID-19, rather than a temporary easing of rules to get over the immediate blow from the crisis.

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

- Our assessment of fiscal affairs reform is unchanged this quarter. Local governments' fiscal balance barely budged, with weak revenue due to COVID-19 offset by a decline in spending.

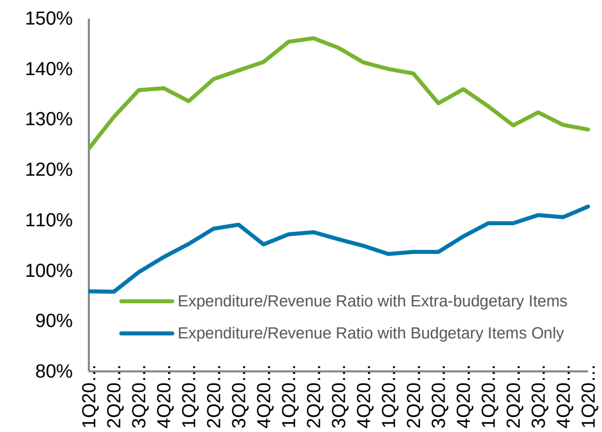
- The budgetary fiscal gap widened further because of a drop in tax revenue, straining local finances. Larger bond issuance and a sharp fall in off-budget spending helped fill the funding gap to some extent.

- Beijing is changing course by allowing localities to roll over debt. While this is a setback for fiscal reform, it will significantly cut local government interest payments, make local debt more sustainable, and improve fiscal health.

This Quarter's Numbers

In 1Q2020, local governments spent far more than they took in, but no worse than in the previous quarter. The augmented **Local Expenditure-to-Revenue Ratio** stood at 128% in 1Q2020, compared with 128.9% in the prior quarter and 132.6% in 1Q2019. The augmented ratio, which includes extra-budgetary channels, improved modestly as local government financing vehicle (LGFV) spending fell sharply (−46.3%) in the first quarter. The decline was a result of the COVID-19 lockdown measures, which prevented migrant workers from returning to work sites.

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



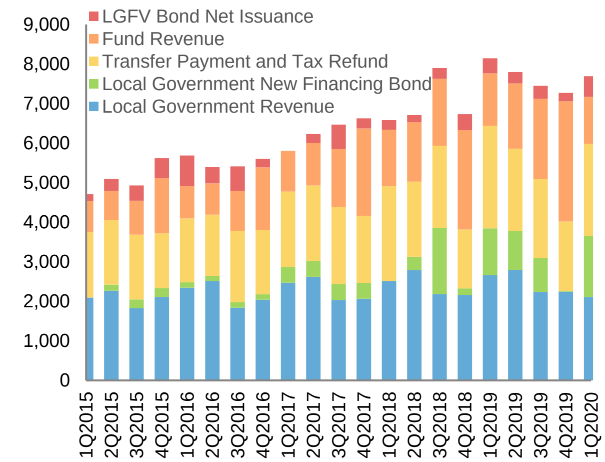
Source: National Bureau of Statistics, Rhodium Group.

The decline in LGFV spending is not sustainable, as Beijing is ratcheting up infrastructure construction to help the economy rebound and offset weakness in the property market, exports, and domestic consumption. With most migrant workers returning to work in the second quarter and infrastructure investment picking up in May and June, spending is expected to increase further, widening the expenditure-to-revenue gap.

While the augmented ratio remained stable, the budgetary funding gap worsened, with expenditure rising to 112.7% of revenue in 1Q2020, its highest level since 1Q2015. Tax revenue took a heavy hit under COVID-19, falling 16.4% year-on-year (yoy) in 1Q2020. Local governments have limited room to adjust budgetary spending with most expenses hardwired, producing a larger gap.

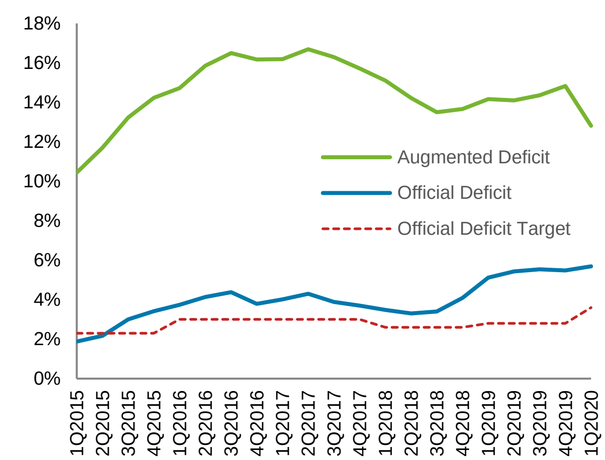
Local spending on social services as a share of total expenditure narrowed this quarter, as local governments cut spending wherever they could in the face of declining revenue. While overall social services spending declined, unemployment benefits were the only category reporting an increase (see **Government Social Expenditures**). This resulted from the surge in unemployment, as more benefits were paid to the jobless and low-income families.

Supplemental 1: Sources of Local Government Financing
Billion RMB



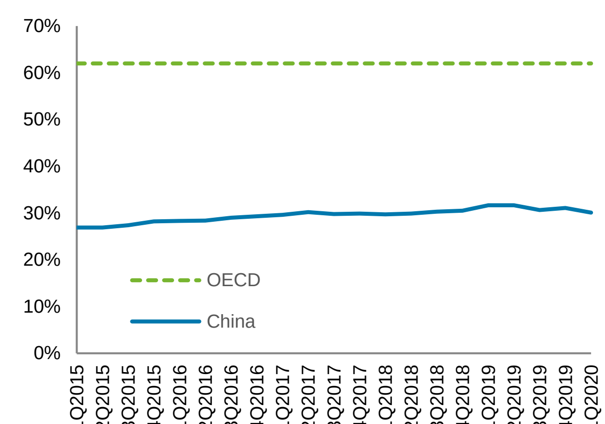
Source: Ministry of Finance, National Bureau of Statistics, International Monetary Fund, Rhodium Group.

Supplemental 2: Fiscal Deficit Measures
4qma, share of GDP



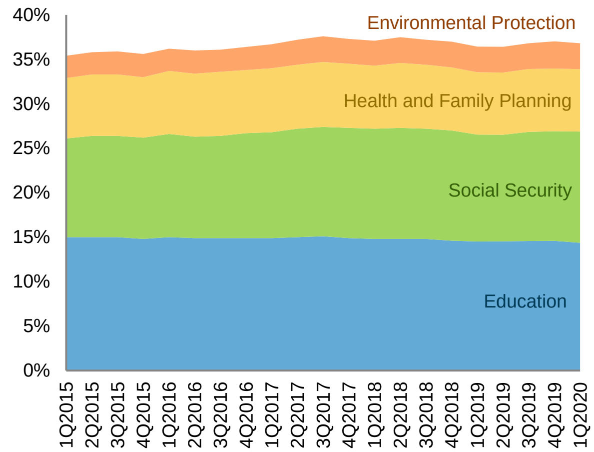
Source: Ministry of Finance, Rhodium Group.

Supplemental 3: Direct Taxation Ratio
4qma, percent



Source: OECD, Ministry of Finance, Rhodium Group.

Supplemental 4: Government Social Expenditures
4qma, percent



Source: Ministry of Finance, Rhodium Group.

Policy Analysis

In the wake of COVID-19, Beijing signaled to markets that it would constrain its fiscal stimulus response by unveiling a smaller-than-expected spending package. In reality, Beijing does not have the ammunition to fire off another stimulus round on the post-crisis scale given the legacy debt from previous rounds. That said, China's leaders are using infrastructure spending as their primary tool to stabilize economic growth, as they did after the global financial crisis. This risks damaging the fiscal health of local governments. Infrastructure investment can boost growth in the short term as it creates demand for construction materials. However, repeated fiscal stimuli have buoyed construction for years, leaving limited room for further infrastructure investment in the more economically developed coastal areas. Beijing is shifting new construction inland; however, these infrastructure projects are unlikely to be profitable, and funding has been scarcer for companies in inland provinces.

Local governments face legacy debt burdens from past infrastructure investments. Another wave of unprofitable infrastructure investment is not conducive to fiscal health and is a clear step backward for center-local fiscal reform.

Local governments are told to spend to lift growth, but taxes to boost their fiscal intake are flat. The bond market continues to provide temporary funding to fill the fiscal gap. Issuance of official local government bonds rose 30% yoy in the first quarter, while LGFV bond issuance increased 38.5%. On the positive side, Beijing is not using fiscal funds to inflate the property bubble to deliver economic growth, as in the past. No local government special revenue bonds were used for property development in the first half of 2020, and we estimate more than 70% of remaining local bonds this year will go to infrastructure construction.

Beijing is shifting its approach to local government implicit borrowing—the indirect debt accrued by local government state-owned enterprises, financing platforms, and borrowing through shadow channels. Prior to the COVID-19 outbreak, Beijing pressed local governments to pay off maturing implicit debt. This contributed to a slowdown in the economy in early 2018. With the pandemic flattening tax income and land sales revenue, that is no longer possible. Policymakers will therefore allow localities to roll over debt—not through expensive shadow borrowing as they had in the past, but with proper bank loans and bonds at lower costs. As a result of this shift, Jiangsu and Yunnan provinces have required LGFVs to retire high-cost implicit borrowing and are prohibiting borrowing at interest rates higher than 7%–8%. This is obviously far from letting markets allocate capital.

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 determinizing 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

- We downgrade our assessment of China's innovation reform progress to neutral this quarter. Innovative industries contributed less to China's economy in 1Q2020, a development that is probably tied to the COVID-19 shock and therefore temporary.

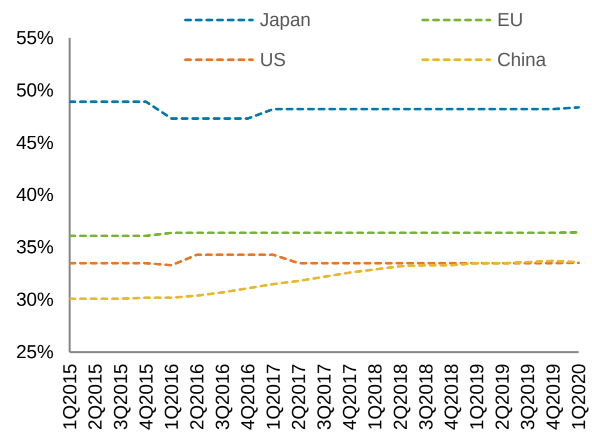
- Five of the seven innovative industries we follow contracted in 1Q2020. Among them, three industries performed worse than the industrial sector average.

- New regulations that promote intellectual property (IP) generation may benefit the innovation environment. Reforms of IP-related laws and regulations are linked to the U.S.-China trade agreement but also reflect the growing need to sustain innovation at home.

This Quarter's Numbers

Innovation played a smaller part in China's industrial economy in 1Q2020. Our primary indicator, the **Innovative Industry Share in Industrial Value-Added (IVA)**, shows a slight decline in China's innovative activity. As of 1Q2020, innovative manufacturing sectors accounted for 33.59% of total value-added in China's secondary industry, on par with the United States (33.52%) but below the European Union average (36.44%).

Primary Indicator: Innovation Industry Share in Industrial Value-added



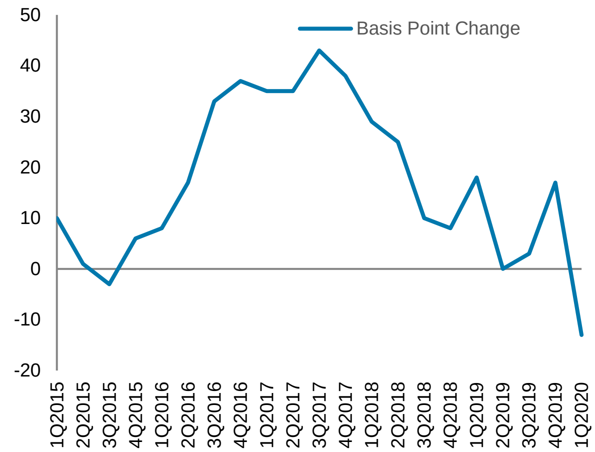
Source: OECD, National Bureau of Statistics, Rhodium Group.

The downturn is likely to be temporary. Economic activity came to a halt after COVID-19 hit, causing the industrial sector to shrink in the first quarter of 2020. Five of the seven innovative industries we follow contracted, and three underperformed the industrial average (see **Industrial Value-Added Growth Rates for Specific Innovative Industries**). Industrial activity has rebounded since April, and this will likely lead to an improvement in 2Q2020.

A robust intellectual property (IP) regime is essential for innovation. As IP is better protected and utilized, China's IP trade flows should increase. In 1Q2020, however, two-way IP flows shrank, with China's IP imports decreasing by almost 10% (see **Intellectual Property Flows**). This is partly the result of the COVID-19 lockdown, which caused China's services imports to fall across the board. However, it may also reflect China's declining payments for the use of foreign copyrights, proprietary manufacturing processes, or computer and software-related licensing..

Supplemental 1: Volatility in Innovative Industry

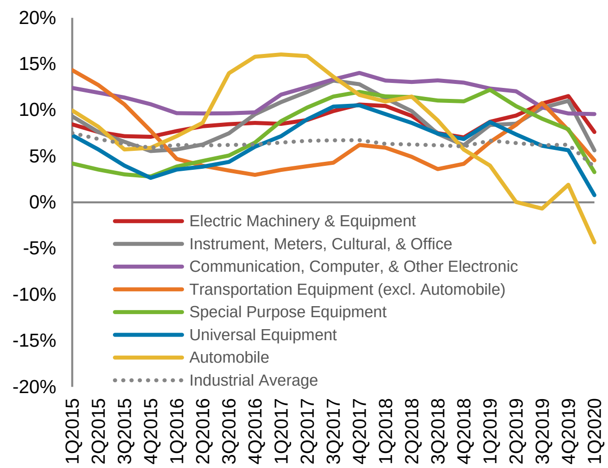
4qma, bp



Source: National Bureau of Statistics, Rhodium Group.

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

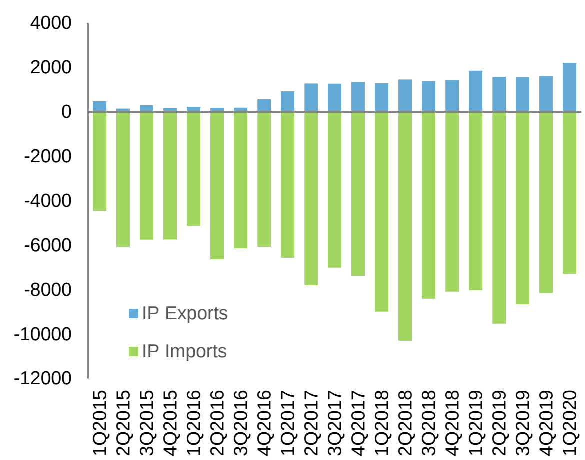
4qma, percent



Source: National Bureau of Statistics, Rhodium Group.

Supplemental 3: Intellectual Property Flows

USD Million



Source: National Bureau of Statistics, Rhodium Group.

Policy Analysis

Our assessment of China's innovation policy reform is more positive this cycle given enhancements to trade secrets protections and trademark reviews.

The China National Intellectual Property Office (CNIPA) has launched several initiatives since April to strengthen IP protection. On April 22, the CNIPA released a 2020–2021 work plan that puts the November 2019 State Council/CCP Central Committee "Opinions on Strengthening the Protection of Intellectual Property" into force (see **Winter 2020** edition). The scope of this plan is broad, going beyond the IP commitments made in the January 2020 U.S.-China Phase One trade agreement. With 133 action items, the plan calls for patent legislation advancement, establishment of a China International IP Arbitration Committee, and the building of a National IP Data Center. The action items come with specific deadlines, which add further credibility.

On May 28, the CNIPA unveiled another initiative, "100 Priority IP Projects for 2020," which commits to completing patent reviews with a high market value potential within 16 months and shortening the average trademark review cycle from five months to four. The initiative noted that while China is a global leader in the *volume* of patents, the quality of those patents is inconsistent. The CNIPA called for an end to locally subsidized patents, which have low innovation content and are generated only to meet local performance goals. Task 66 in the plan calls for better information disclosure for public R&D projects and improving the evaluation of IP assets in state-owned enterprises (SOEs). These measures are tailored to improve the quality of the domestic innovation system.

Developments in the legal sphere were also encouraging. On June 9, the Supreme People's Court (SPC) issued a draft Judicial Interpretation of the civil trade secret law. Judicial Interpretations are quasi-legal SPC enactments that can have the force of law. Legal commentators noted the interpretation moved China's trade secrets protection regime closer to U.S. legal practice, which is positive. Subsequent Judicial Interpretations have addressed practical issues in IP litigation, such as evidence preservation and expert appraisal. China's recent efforts to reform IP-related laws and regulations are partially motivated by the U.S.-China trade agreement but also go beyond those commitments in some cases. This suggests that officials in Beijing are aware that the environment for innovation needs serious improvement for the sake of domestic economic growth and development.

Labor

The Story So Far

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

- In July 2014, authorities issued an *Opinion* that called for relaxing the burdensome restraints on individuals who wished to change their residency (the household registration or *hukou* system). This new policy eased controls for those wishing to move to smaller cities while leaving in place more restrictive measures for those wishing to move to bigger cities. Policymakers also planned to set up a nationwide residency permit system that would ease and standardize the process of relocating.

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

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

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

Methodology

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

Quarterly Assessment and Outlook

- We further downgrade our assessment in 1Q2020. All labor indicators deteriorated and are now in unchartered territory as policies failed to support workers during the pandemic.

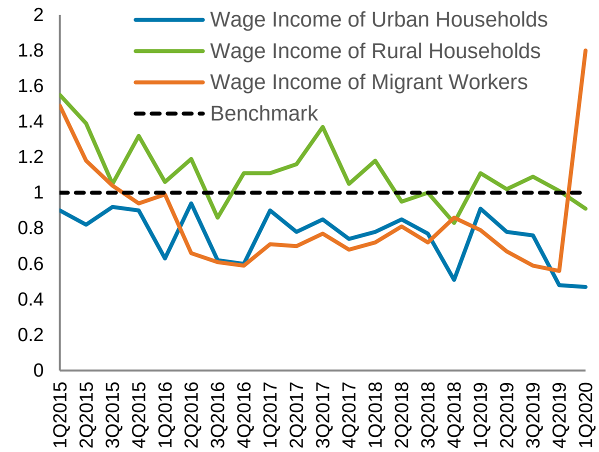
- Migrant workers were hit harder than other groups. Price-adjusted migrant wages fell 12.3% in 1Q2020, while urban and rural workers' wages fell at a slower pace.

- Beijing rolled out policies to help small- and medium-sized enterprises support workers and households. This policy support sends an important signal, but its effectiveness will depend on a recovery in the global economy.

This Quarter's Numbers

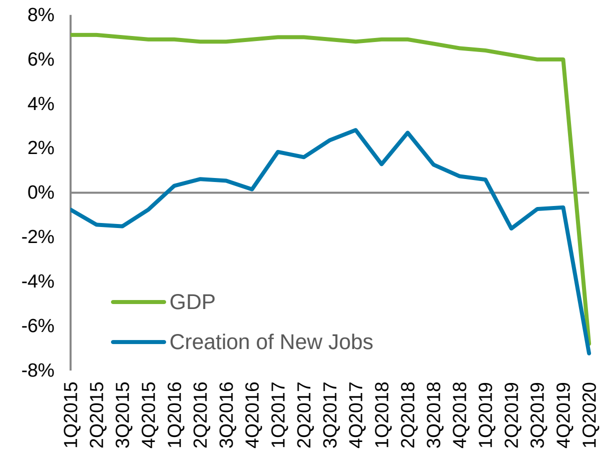
Labor indicators plunged as the pandemic hit China in 1Q2020. Migrant workers proved to be more vulnerable than other workers, despite past policies that promised to reduce job discrimination and expand the social safety net. As China's GDP fell by 6.8% year-on-year (yoy) in 1Q2020, price-adjusted migrant worker wages contracted by 12.3%, more than the fall in urban wages (−3.2%) and rural wages (−6.2%). While price-adjusted migrant wage growth was the weakest, the wage-to-GDP growth metric in our primary indicator shows a misleading improvement as migrant wages contracted even more than GDP growth, producing a number greater than 1.

Primary Indicator: Wage Growth Relative to GDP
Ratio



Source: National Bureau of Statistics, Rhodium Group.

Supplemental 1: New Job Creation
Yoy, percent



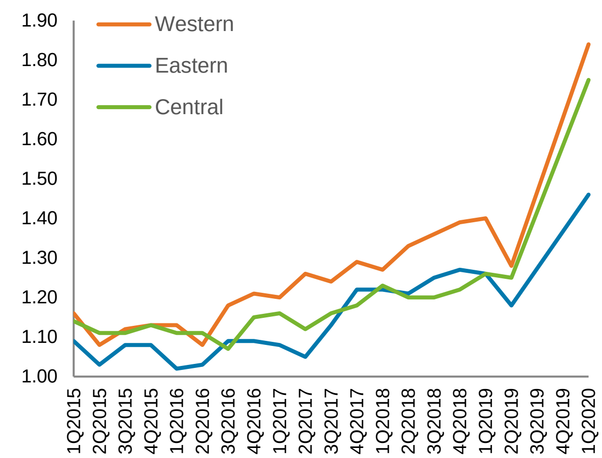
Source: Ministry of Human Resources and Social Security, National Bureau of Statistics.

Official unemployment data failed to reflect the shock to China's workforce. The National Bureau of Statistics (NBS) reported a 5.9% unemployment rate in March, compared with 5.2% in December 2019. The official rate is at odds with transportation data that suggest that 40% of China's 290 million migrant workers—15% of the country's total workforce—had not returned to the workplace by the end of 1Q2020.

In addition, China created only 2.3 million jobs in 1Q2020, 29% fewer than in 1Q2019 (see **New Job Creation**). Many of the jobs created are beyond the reach of those in need given travel restrictions and quarantine measures. In 1Q2020, the ratio of job openings per applicant spiked in all regions, reaching the highest levels on record (see **Labor Demand-Supply Ratio**). The ratio of job openings per applicant has consistently increased since 2016, pointing to structural rather than cyclical problems in China's labor market and the failure of past policies to address skills training, unfair compensation, and other problems.

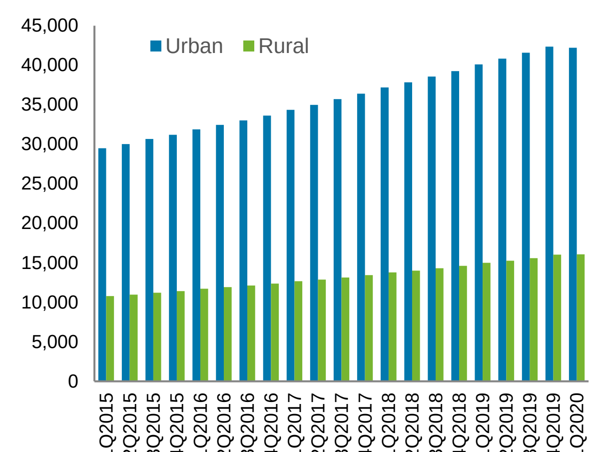
Despite the pandemic and worsening labor market conditions, the government's social spending as a share of GDP barely changed (see **Social Spending**). Compared with 1Q2019, the government spent only 1% more on social security and employment, 2% more on healthcare, and 7% less on education in 1Q2020. The increased spending on social security and healthcare is wholly insufficient to meet the needs of China's households.

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



Source: Ministry of Human Resources and Social Security.

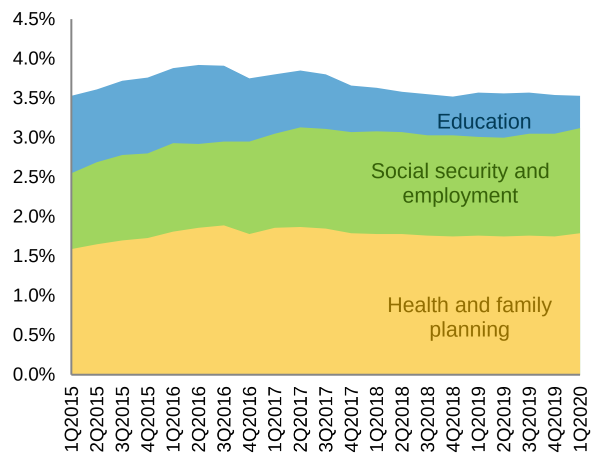
Supplemental 3: Rural-Urban Household Income
Annualized RMB



Source: National Bureau of Statistics.

Supplemental 4: Government Social Expenditures

4qma, percent



Source: National Bureau of Statistics, Ministry of Finance.

Policy Analysis

Beijing is now prioritizing employment policies to address weak labor conditions. On April 17, the Politburo Standing Committee made employment the highest priority in the "six ensures" and the "six stabilities," two new policy slogans that encapsulate Beijing's focus for the year. The government work report released on May 22 mentioned the word "employment" 39 times, 30% more than the report in 2019, even though the report itself is much shorter. The report dropped the growth target but kept the goal to eliminate poverty this year, one of the three objectives President Xi pledged to accomplish in 2020 at the 19th Party Congress in 2017.

China's labor policies in response to COVID-19 have focused on helping small businesses support employment. The State Council Executive Meeting announced measures on March 31, April 21, June 17, and July 1 to support lending to small- and medium-sized enterprises (SMEs) and to lower their borrowing costs. The annual government work report extended the reduction of social security payments and electricity charges that firms pay, originally set to expire in June, to the end of the year, and suspended debt service payments for SMEs until March 2021. On June 1, China's central bank announced it would purchase some SME loans to encourage local banks to increase lending to them. Together, these measures are expected to reduce firms' costs by around RMB 1–1.5 trillion (USD 143–214 billion) for 28 million SMEs, supporting roughly 84 million workers if one assumes that each SME employs three people.

The government also signaled support for "street businesses," suspending decades-long efforts to clean up China's informal economy. On June 1, Premier Li visited a city in Shandong province and praised street vendors as the "vitality of China's economy." In effect, any seller can open for business without paying rent or taxes. According to reports, authorities that had previously been tasked with chasing vendors off the streets were asked to focus instead on finding new street vendors.

So far, rising unemployment due to COVID-19 has not threatened China's political stability. If anything, the rise of infections outside China has reinforced the legitimacy of the government's crisis response. Workers appear unwilling or unable to take collective action. According to the China Labor Bulletin, workers only conducted 118 strikes in 1Q2020, less than a third of the number (369) in 1Q2019. However, the risk of popular pushback remains: a significant portion of China's 180 million workers in export-related sectors face unemployment risks as global demand declines, and there is no way for China's domestic consumption to fill the gap left by the world.

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 until the end of 2019.

- 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.

- China revised the Rural Land Contracting Law in December 2018 to codify the division of "land use rights" and "land management rights" and to extend rural residents' rights to agricultural land for another 30 years. China also revised the Land Management Law in August 2019 to allow rural nonagricultural land to enter the urban land market but only under strict conditions with heavy involvement of the government. This revision is below expectations and will limit the scope of future reform.

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

- We upgrade our assessment of land reform this quarter. Some localities are starting to allow rural land to be sold in the urban market and increasing compensation to rural residents as promised in the 2013 Third Plenum.

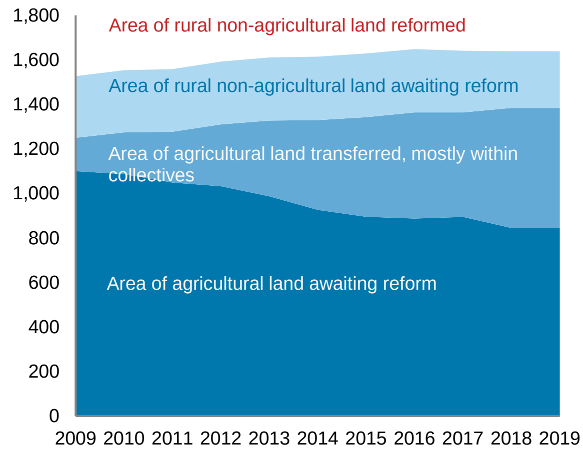
- Rural nonagricultural land transferred at market prices remains just 0.1% of China's total rural nonagricultural land by area, as new pilots have not yet made any progress.

- Authorities are considering a more flexible approach toward transferring rural property-use land. This is positive, but it is not at the implementation stage. Improved land supply measures should help rebalance China's urban and rural development in the long term.

This Quarter's Numbers

Nonagricultural land reform remained stalled in 1Q2020, with the area of reformed land at just 0.1% of China's total rural nonagricultural land area. Authorities did not update land reform data, as new pilots launched in December 2019 may take a year or more to result in market land transfers.

Primary Indicator: Land Marketized
Million mu (1 mu ≈ 1/6 acre)



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

Some progress is emerging at the local level though. In accordance with the revised Land Management Law (see **Fall 2019 edition**), Jiangsu province increased compensation guidance for state purchases of rural land in May. Government entities in Jiangsu, a coastal province north of Shanghai, now need to pay at least RMB 20,000 (USD 2,857) per mu and RMB 20,000 per person for each plot of land acquired, up from RMB 1,200 (USD 171) per mu and RMB 11,000 (USD 1,571) per person as specified in the 2015 guideline. We expect more provinces will follow Jiangsu and revise their compensation standards. These changes amount to a partial reform: while rural residents in Jiangsu must still sell their land to the government, they will be compensated at prices that are closer to market rates.

In addition, Shanghai is now allowing rural land to be transferred at market prices like urban land. Guidelines revised in April stipulate that rural land can now be sold in the same way as urban land, removing an administrative barrier for reform pilot programs. In June, Songjiang, a district of Shanghai and one of the first land reform pilots, announced a plan to include 275 mu of rural land in its 2020 urban land supply, accounting for 10%–20% of the total amount. This reflects accelerated reform as Songjiang sold only 317 mu of rural land in the past five years.

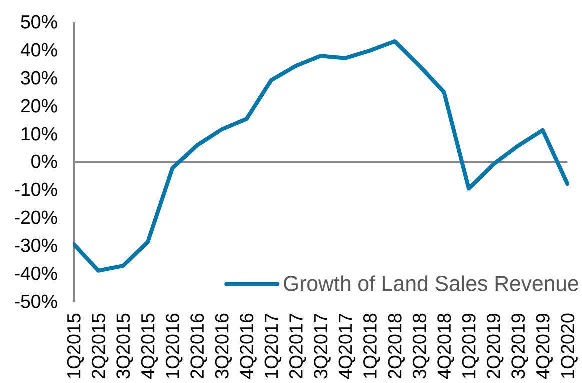
While local governments are starting to pay more for rural land, they will likely earn less from selling it to developers. Urban land price growth has stabilized as property market restrictions remain in place and the property sector endures a structural slowdown. In 1Q2020, commercial land prices in Tier 1 cities grew by only 0.1% year-on-year (yoy), the slowest rate since the dataset started in 2014 (see **Urban Land Prices**). Land prices for other use (residential or industrial) and in other cities (Tier 2 and Tier 3) also rose by a smaller margin and slowed in 2Q2020, even after China's economy started to recover from COVID-19.

Rising buying costs and weaker selling prices should limit local governments' ability to profit from and reduce their reliance on land sales, which has been a key obstacle to land reform. But changing incentives will take time to change local government behavior. As of 2Q2020, local governments are even more reliant on land sales: fiscal revenues shrank under COVID-19 while land sales revenue increased as the property sector led China's recovery (see **Land Requisition Financials**).

While reform of rural nonagricultural land policies has been slow, rural residents still benefited from agricultural land reform, which now allows the transfer of rural land-use rights for large-scale farming or other agricultural purposes in 15 provinces. For rural residents, property income rose 1.5% yoy in 1Q2020 and 13.8% in 2Q2020 while all other income was hit by the pandemic.

Supplemental 1: Land Requisition Financials

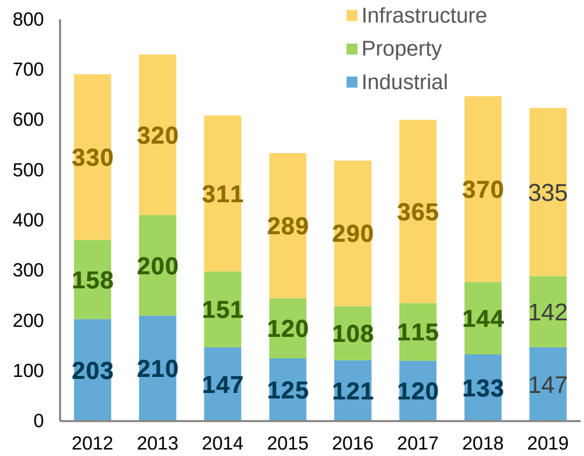
Year-over-year, percent



Source: Ministry of Finance, Rhodium Group.

Supplemental 2: Urban Land Supply by Use

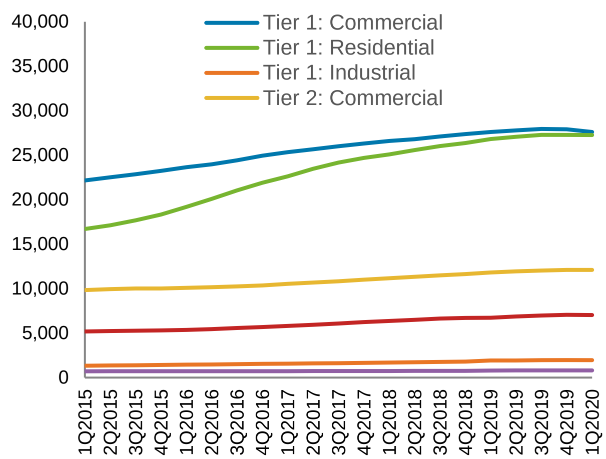
Thousand Ha



Source: Ministry of Natural Resources.

Supplemental 3: Urban Land Prices

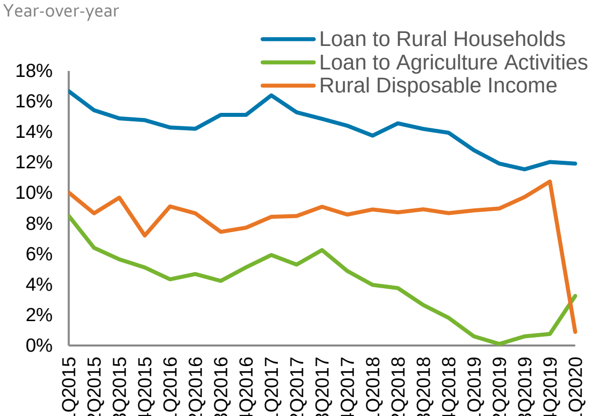
RMB per square meter



Source: Ministry of Natural Resources.

Supplemental 4: Rural Credit

Year-over-year



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

Policy Analysis

Following the June 30 Central Commission for Comprehensively Deepening Reform meeting, authorities are considering allowing more flexible treatment of rural property-use land while maintaining rural residents' titles to it, similar to the approach taken with agricultural land reform. In other words, rural residents may be able to lease out their land so that others can build on it or they can receive rental income for residential use. Like agricultural land reform, this reform is incomplete, as it does not involve transfer of ownership; however, it can still benefit rural residents by improving the productivity of their land and increasing the income they derive from it.

The Ministry of Natural Resources also made an important announcement in 2Q2020 to improve China's land allocation. On June 2, the ministry issued guidance for 2020 requiring land supply to "follow real projects," reversing the principle of "using land supply to attract investment" in previous guidelines. The ministry will reduce land supply quotas for local governments that failed to utilize their quotas in previous years.

This move reflects the spirit of the April joint Communist Party–State Council opinion urging more effective market allocation of resources including market-based pricing of land and better compensation for rural land (see **Spring 2020 edition**). Implementation of the land supply notice is easier now because the State Council delegated the power of approval for rural-urban land conversion to provincial governments in March.

State-owned Enterprise

The Story So Far

Reforming state-owned enterprises (SOEs) is critical to improve the competitive environment within China's economy and in overseas markets where Chinese firms are engaged in trade and investment. Unlike other commercial entities, SOEs are tasked with economic and political objectives. The crux of SOE reform is delineating and separating these commercial and political activities.

During the 1990s, Beijing tried to reform the state sector by consolidating state control over large SOEs while withdrawing from small ones, which contributed to private sector prosperity and a decade of strong economic growth. In the 2000s, Beijing redefined SOE "reform" as concentrating state control over key and pillar industries with strategic linkages to China's economic development and national security.

In 2013, the Third Plenum further clarified SOE reform as transforming SOEs into modern corporations, with the state exercising influence in the same fashion as other shareholders. The Third Plenum also envisioned that the state would reduce control of commercial SOEs while pushing SOEs in strategic industries to focus on their "core" business areas.

- Starting in 2014, Beijing tried to improve SOEs' competitiveness using ad hoc measures, such as mergers and mixed ownership programs (similar to those used in the 1990s) involving the sale of minority shares to private firms. These piecemeal efforts continue today. However, none of these measures has been sufficient to reshape SOEs' incentives in line with market principles or redefine their role within the economy.

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

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

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

Methodology

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

Quarterly Assessment and Outlook

- We slightly upgrade our assessment of state-owned enterprise (SOE) reform from 4Q2019, but on net it remains negative. SOEs took a smaller share of revenue and assets in 1Q2020 as private firms navigated the pandemic better; however, an acceleration in SOE investment points to their larger role in the future.

- Private firms outperformed SOEs across all our indicators in 1Q2020. After a weak first quarter, private firms have rebounded in 2Q2020, whereas SOEs are still losing revenue.

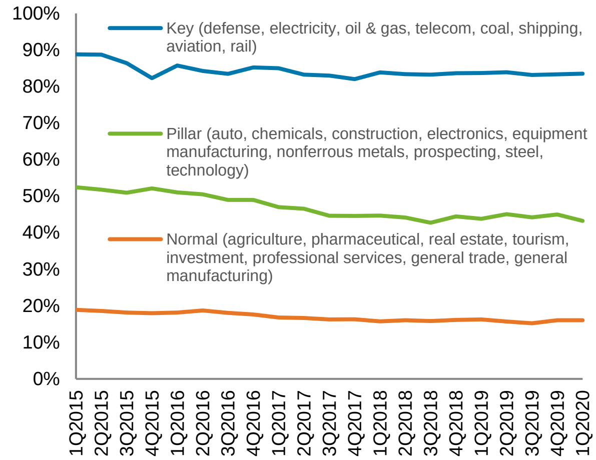
- Rather than reducing SOEs' influence, Beijing is utilizing them more strategically amid COVID-19. Authorities have tasked SOEs with increasing profit, investing more in strategic sectors, and helping secure supply chains for domestic firms.

This Quarter's Numbers

In the first quarter of 2020, Beijing leaned heavily on SOEs to respond to COVID-19 and kick-start economic activity, but this has not yet translated into a bigger SOE presence in the economy. Among all listed firms, SOEs saw revenues fall 14% year-on-year (yoy) in 1Q2020, while private firm revenues declined by 10%.

Primary Indicator: Share of SOE Revenues in Different Industry Categories

4qma, percent



Source: Bloomberg, Rhodium Group.

Our primary indicator gauges how revenues for listed state and private firm compare across industries. In "key" industries, where the state plays a dominant role for national security reasons, SOE presence increased slightly (see **The State's Share**). But in "pillar" industries that Beijing considers strategic for China's economic development, SOEs accounted for a smaller share of revenues. In "normal" industries where Beijing has promised to withdraw state influence, SOEs maintained roughly the same share relative to private firms.

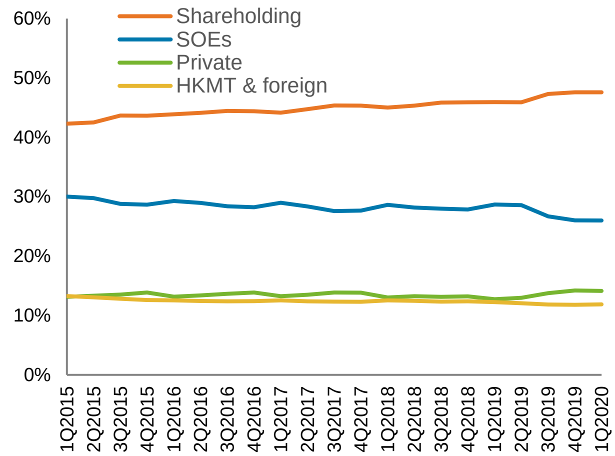
Among unlisted industrial firms, SOEs also underperformed private firms. Unlisted SOEs saw revenues fall 13% yoy in 1Q2020, a steeper decline than the 10% loss for unlisted private firms. SOEs continued to lose revenue in April and May while private firms' revenues have rebounded. In terms of profit, SOE performance was even worse: profits shrank by 16% yoy in May as private profit grew by 8%. State firms also accounted for a smaller share of industrial assets in 1Q2020 (see **Industrial Assets by Ownership**).

The overall improvement of these indicators is partially related to advancements in SOE reform made in 2019. In the **Spring** and **Winter 2020** editions, we found that the State-owned Assets Supervision and Administration Commission (SASAC), the owner and regulator of SOEs, had restructured more than 100 SOEs since August 2018, leading to their reclassification as private firms, thereby reducing reported SOE assets in 2019 and 2020.

The improvements recorded during the first quarter of 2020 do not mean that private firms are enjoying fair and equal treatment relative to state firms. Quite the opposite: authorities are counting on SOEs to lead China's recovery. While SOE investment fell 12.8% yoy in 1Q2020, it increased by 9.7% in 2Q2020. By comparison, private investment fell 18.8% in 1Q2020 and declined by another 5.7% in 2Q2020. According to SASAC, central SOE investment has risen every month since March. These investments may not have been reflected in SOE asset growth so far (they can simply reclassify assets from cash to investment if the initial amount is paid out of pocket), but they will be recognized as such eventually and contribute to an even more expansive state sector.

Supplemental 1: Industrial Assets by Ownership

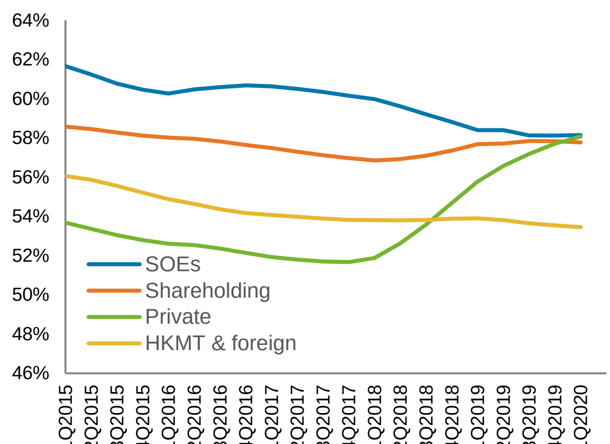
Percent



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

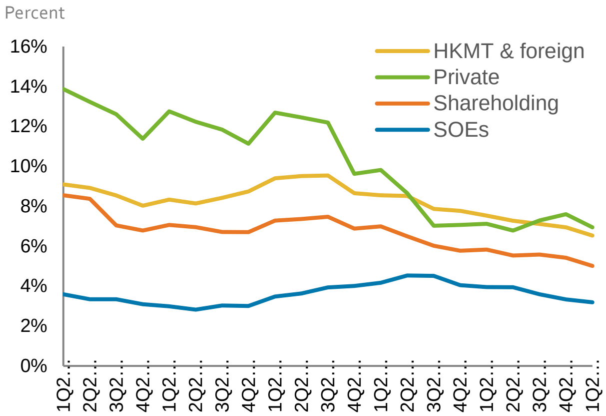
Supplemental 2: SOE Leverage

12mma, percent



Source: National Bureau of Statistics, Rhodium Group.

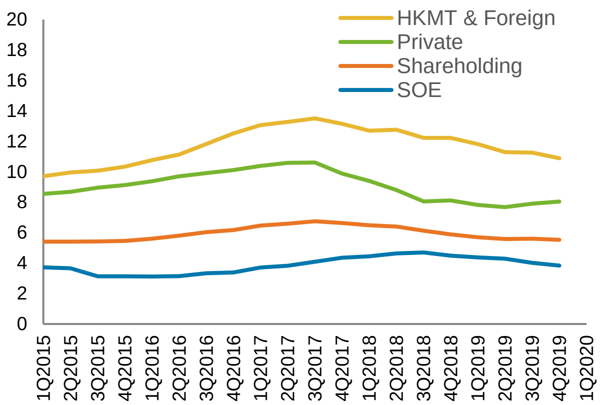
Supplemental 3: Return on Assets



Source: National Bureau of Statistics, Rhodium Group.

Supplemental 4: SOE Interest Coverage Ratio

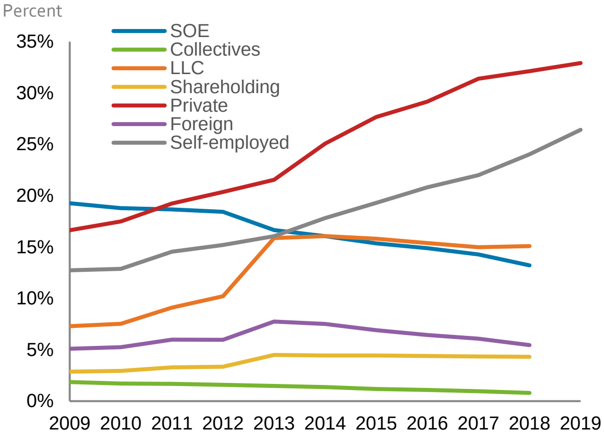
Profit to interest ratio, 12mma



Source: Bloomberg, Rhodium Group.

Supplemental 5: SOE Share of Employment

Percent



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

Policy Analysis

Beijing sent three main signals on SOE reform in the first half of 2020. First, it tasked SOEs with preventing disruption of domestic company supply chains. Second, it instructed SOEs to improve profitability. And third, it told SOEs to reallocate capital from sunset industries to strategic industries. Rather than reducing their influence in the economy, Beijing is trying to utilize SOEs more effectively.

Beijing has called on SOEs to protect critical supply chains. On April 20, SASAC promised in its first quarter press conference that central SOEs would play a key role in maintaining the stability and competitiveness of domestic company supply chains and in strengthening international cooperation to ensure access to global supply chains. On April 22, President Xi visited a Shaanxi provincial automobile SOE and urged state firms to help out private firms across auto manufacturing supply chains. In practice, SOEs were required to resume work as early as possible to fulfill downstream orders, create new demand for upstream products, and provide liquidity to their customers and vendors.

While SOEs shouldered extra costs associated with Beijing's political orders, they were still expected to increase profits. On May 18, the Party and the State Council jointly published an opinion ("Guidance on Speeding Up the Improvement of the Socialist Market Economic System in the New Era"). The document proposed that commercial SOEs sell assets in capital markets as a measure to improve the allocation of state capital and increase returns. It even introduced the idea that the state might convert some of its shareholdings in SOEs to preferred shares. Holders of preferred shares are guaranteed a stable dividend payout but have no voting rights. If the plan proceeds, it would encourage SOEs to act more like commercial entities.

Finally, SOEs were told to invest more in strategic sectors. On June 30, the Central Deepening Reform Commission passed a three-year action plan for SOEs (2020–2022). SASAC started developing the plan in November 2019 and is slated to finish it by October 2020. While the full text of the plan is not yet publicly available, the meeting's readout signals that Beijing has no intention of reducing state influence over the economy. Instead, the main theme of the plan appears to be strengthening the Party's role within SOEs; reallocating state capital toward strategic sectors; and improving SOE competitiveness, innovation capacity, control, influence, and risk resistance. The plan mirrors President Xi's rhetoric at the Fourth Plenum last November devoted to Party affairs. It is difficult to square these signals with the April and May guidance on letting the market play a more important role in allocating resources. An incoherent roadmap for SOE reform ultimately darkens the reform outlook.

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 implemented multiple rounds of import tariff cuts starting in 2015 on a wide range of goods, with a focus on information technology and consumer goods. These tariff cuts reduced the normal, non-discriminatory ("most-favored nation") simple average tariff to 7.5% in 2018 from more than 9% in 2013 and slightly reduced trade-weighted average tariffs to 4.4% in 2017 from 4.6% in 2013.

- Beijing prioritized "trade facilitation reform" (simplification, harmonization, standardization, and transparency) when it ratified the WTO Trade Facilitation Agreement (TFA) in 2015. The government formed a national committee on trade facilitation in March 2016. After piloting reforms in the Shanghai Free Trade Zone in 2015, Beijing issued several policies to transition to a "single window" system nationwide to simplify trade inspections, declarations, taxes, and other procedures. China was ranked 46th by the World Bank in "Ease of Doing Business" in 2018, a significant improvement from 78th the prior year, in part due to lower trade-processing delays and costs.

- China's leaders emphasize the importance of increasing imports to facilitate both internal and external rebalancing. To stimulate imports and consumption, Beijing tested a series of policies, starting in the Shanghai Free Trade Zone 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 2Q2019, we replaced the original Composite Trade Liberalization Index (CTLI) 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, cyclical patterns, competitiveness conditions, and global trade conditions may impact the indicator.

Quarterly Assessment and Outlook

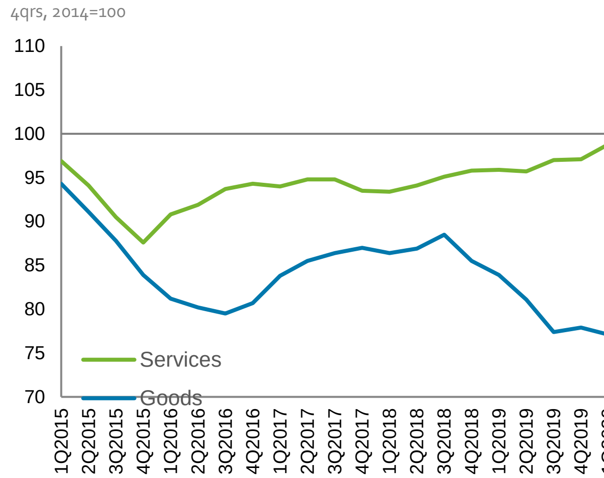
- Our assessment of trade policy reform in 1Q2020 is unchanged from the prior quarter. Imports for consumption declined even more than GDP growth, while services imports (excluding tourism) improved but remain below the 2014 level.

- The COVID-19 pandemic disrupted trade patterns significantly. Restrictions on workforce migration and activity reduced Chinese exports more than imports. As a result, China's current account surplus narrowed and overcapacity goods exports fell.

- China's trade policy focus shifted in 1H2020 away from implementation of its Phase One deal with the United States toward coping with the economic fallout from the COVID-19 crisis. A new focus on "internal circulation" suggests that domestic economic drivers are being prioritized in anticipation of weaker external demand.

This Quarter's Numbers
Trade was altered by COVID-19, making new conclusions about trade openness impossible. Our primary indicator, the **Composite Trade Liberalization Index (CTLI)**, shows increased openness in services trade but a continued decline in goods trade in 1Q2020. China's goods imports in 1Q2020 fell by 2% in value terms due to falling oil prices but rose by 6.7% in volume terms, led by rising imports of raw materials. Those aside, the CTLI (which excludes crude oil, iron ore, and integrated circuits) shows imports for consumption falling relative to GDP: a negative for trade reform.

Primary Indicator: Alternative Trade Liberalization Index



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

The COVID-19 crisis reduced China's exports more than its imports in 1Q2020. Restrictions on workforce migration and nonessential economic activities affected labor-intensive manufacturing, causing exports to decrease significantly, which led to a rare current account deficit of USD 34 billion in the first quarter. Weak exports reduced China's *goods* trade surplus to 0.8% of GDP in 1Q2020, down from 2.3% in 1Q2019 (see **External Trade**). This rebounded in the second quarter as production resumed and demand for medical and protective equipment abroad surged. A weaker renminbi helped (see **Exchange Rate Fluctuation**).

Services trade was also negatively affected by the pandemic. Fallout from the virus led to a 14.5% decline in the services trade deficit in 1Q2020, with exports falling 8.4% year-on-year (yoy) and imports by 17.6%. Tourism and transportation services accounted for most of the fall as people traveled much less, with Chinese travelers spending USD 19 billion less abroad on tourism in 1Q2020 than in 1Q2019. Our metrics of **Services Trade Openness** exclude tourism, which typically reflects some capital outflows in addition to tourism spending. While most service sectors saw imports fall in 1Q2020, telecommunications, computer, and other information services imports surged 34% yoy to USD 8 billion. Telecom exports have continued rising for 10 consecutive quarters.

Other indicators point to the improved structure of China's trade (meaning less reliance on export-oriented growth) but reflect COVID-19 distortions. Intermediate imports used as manufacturing inputs and reexported have continued to fall relative to total exports (see **Structural Change in Goods Trade**), which normally would indicate economic growth that is less export led and more consumption driven, but the CTLI indicates imports for consumption remain weak. Likewise, China's net exports of overcapacity goods like steel and aluminium products have fallen relative to previous quarters (see **Trade in Overcapacity Goods**), but this reflects the shock to external demand and reduced domestic activity from the pandemic, rather than a meaningful resolution of problems related to unproductive firms.

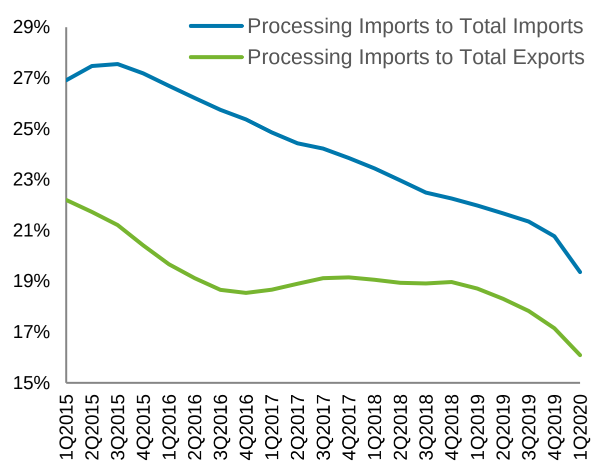
Supplemental 1: External Trade

Percent

Source: State Administration for Foreign Exchange.

Supplemental 2: Structural Change in Goods Trade

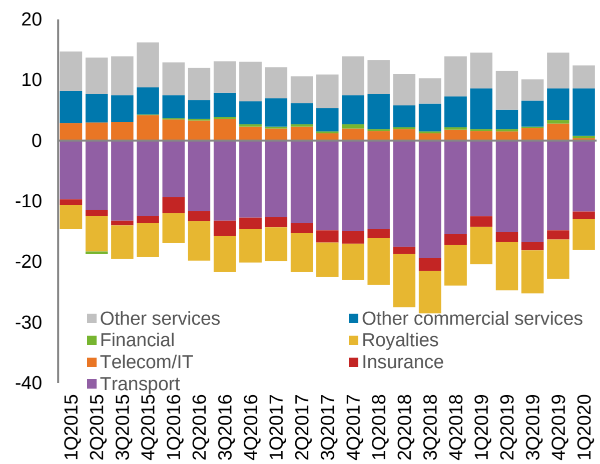
Percent



Source: General Administration of Customs.

Supplemental 3: Services Trade Openness

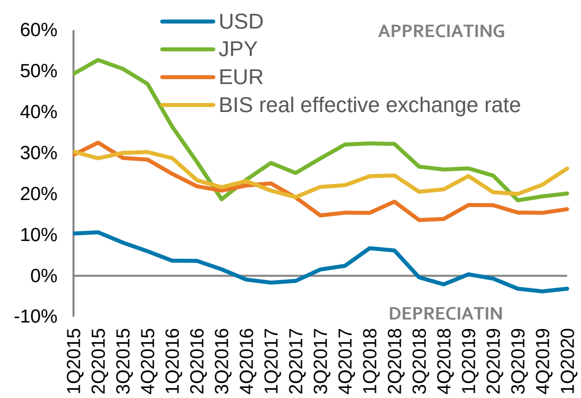
USD Billion



Source State Administration of Foreign Exchange.

Supplemental 4: Exchange Rate Fluctuation

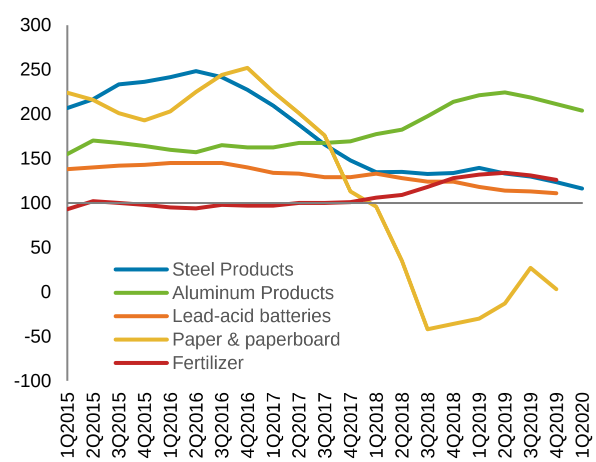
Percent



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

Supplemental 5: Trade and Overcapacity

Index, 2012=100



Source: General Administration of Customs, Rhodium Group.

Policy Analysis

China's trade policy focus in 1H2020 shifted from managing the U.S. trade relationship and implementing the Phase One trade deal to responding to the economic fallout from the COVID-19 pandemic. Beijing has signaled that it plans to focus increasingly on domestic economic drivers, raising questions about its future trade openness.

Implementation of the purchasing targets contained in the Phase One deal has been slow at best. In the first six months of 2020, China met 57% of its full-year 2020 import target in manufacturing goods, 39% of agricultural products, and 22% of the target in covered energy products, according to the Peterson Institution for International Economics (PIIE). For other commodities (for which there are no targets), U.S. exports to China fell by 28%, compared with a 2017 baseline. These targets are increasingly unrealistic due—in addition to their questionable initial design—to the COVID-19 crisis and the mounting political tensions between the United States and China. The looming U.S. election could also be a factor in how China approaches its trade relationship with the United States for the remainder of 2020. China's implementation of the "rules" part of the Phase One deal, in such areas as intellectual property rights, financial services, and agriculture non-tariff measures, appears to be largely on track.

The COVID-19 outbreak transformed Beijing's thinking on trade policy. With employment a growing concern, China's government is doubling down on labor-intensive industries. In the past, policy had been aimed at shifting out of labor-intensive industries in the export sector, as they were seen as less innovative and less competitive. But a State Council Executive Meeting, held on July 22, prioritized the development of such industries. Mid-year data suggest a shift in exports to emerging markets (Africa, Latin America, ASEAN) from the United States and the European Union. Ultimately, an economic plan that reverts to polluting, investment-intensive exports is a step backward for reform.

Employment is also a focus of the new internal circulation strategy, which was discussed at Politburo meetings in May and July. The strategy aims to shift the economic balance toward China's vast domestic market, although China's leaders have stressed that they are not turning their back on international trade. In part, the approach reflects a new reality of weaker external demand tied to virus-induced economic slumps around the world combined with growing questions about economic engagement with China within the United States and other OECD countries. Elements of this new strategy are likely to feature in the 14th Five-Year Plan—China's most important medium to long-term economic development strategy for 2021–2025, to be unveiled early next year. By elevating the focus on domestic market demand, Beijing is acknowledging a tougher and less predictable external environment.