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ABOUT THE TEAM:

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

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

Gauging China’s Policy Reform Intentions: Past, Present and Future

The idea of a “dashboard” to gauge Beijing’s progress in implementing its economic reform plans was born from the hopeful Sixty Decisions of the Chinese Communist Party (CCP) issued in November 2013. The Party Decisions, accompanied by a personal essay by President Xi Jinping explaining them, committed to make markets the “decisive” factor in the country’s long-term economic direction. As optimists cheered and pessimists snickered, we set out to track implementation to see if China actually did it. We began in late 2015 with design work and then published quarterly evaluations from the fall of 2017. This winter 2020-2021 edition is the last in a five-year program. We offer final observations on the march from 2013 pledges to 2020 deadlines, a look at new policy announcements at the margin today, and our perspective on the future.

Yesterday: Avoid the Blind Alley

Observers were unsure what to expect of Xi Jinping when he came to power in 2012. The global financial crisis had disrupted growth, triggering a wave of stimulative debt that was undermining productivity. Internal politics were a challenge, with powerful vested interests able to block needed reforms just as the middle-income trap arrived. Some intellectuals advocated liberal solutions for the economy administered by a regulatory state. Other so-called “new left” voices counseled a more doctrinaire course emphasizing China’s brand of Marxist-Leninist authority. President Xi’s inaugural economic plan issued in November 2013, discussed at length in our report Avoiding the Blind Alley, had something for both sides. There were hundreds of pro-market objectives, but a commanding role for the state was retained as well. On the whole, the plan’s liberal elements were a surprise on the upside. We surmised this was intentional: expectations like these are not set by accident or as a feint.

Seven years have passed since then. Efforts to make good on the Decisions have come and gone, and in some cases come again. Reforms have generally been halted when they led to instability, which is most of the time. Industrial policies such as Made in China 2025 grew ever more heavily weighted in explaining China’s directions as the counterbalancing role of reform diminished. And over these seven years, with China breaking the $10 trillion GDP mark in 2014 (approaching $15 trillion today) and now taking off as a global direct investor, the less-liberal forces shaping outcomes inside China have begun spilling ever more quickly abroad.

Of the 10 clusters into which we consolidated the many commitments in the Party’s 2013 Decisions, six have seen reform run backwards (or stalled) on net, while four have seen some modest advancement.

The Good

Fiscal affairs, cross-border investment, innovation, and environment are the four areas that showed some progress. In fiscal affairs, the biggest improvement came from moving local government financing on the balance sheet by shifting from shadow financing to local government bond financing. While local bonds were introduced in 2015, bond financing did not take off until 2018 to offset the reduction in illicit financing due to deleveraging. This has helped bridge the local fiscal gap with more revenue and increased transparency and has helped with overall debt sustainability.

The improvement in cross-border investment is recent. Two-way capital flows relative to GDP fell consistently from 2016 to early 2019, but they have picked up in the past four quarters due to reduced barriers to inbound portfolio investment – reinforced by a dearth of opportunities worth investing in elsewhere in the world.

In innovation policy, China also achieved consistent progress. This reflects the strong state role in driving investment and rapid growth in innovation-intensive activities, but all at the cost of low investment efficiency, overcapacity, and market discrimination.

In environmental reform, China has reduced air and water pollution since 2015, though progress stalled in 2020 during the government’s response to the Covid-induced economic downturn. Water quality laws and local enforcement and testing have improved water quality, and this is likely to last. Beijing is trumpeting long-term carbon neutrality goals by 2060. Nonetheless, China simultaneously has been undermining those goals in the near-term by building extra coal power capacity and weakening environmental enforcement to stoke growth.

Reform progressed in these areas out of necessity: this is the overarching story of China’s reform implementation to date. The massive 2009-2010 stimulus left local governments with a decade of unprofitable legacy investments, and the proliferation of unprofitablelegacy financing starting in 2013 meant authorities had little visibility into how localities funded activity. This is a recipe for crisis if left unchecked, and cleaning up local balance sheets was
necessary to avoid that. Beijing dragged its feet on cross-border investment liberalization for years but finally accepted that it could not otherwise attract the capital it needed for the long-term balancing of China’s current account. Air and water pollution got bad enough to threaten Party legitimacy before it was addressed, with worldwide attention adding pressure. In innovation, the change is yet to come: ostensibly it is still improving, China’s technology prowess and the global pushback that is rapidly changing production chains, with huge consequences still to come.

The Bad

This progress was outweighed by significant problems emerging in other critical areas of economic reform announced in the 2013 blueprint. Labor system improvement – defined as workers benefiting proportionally or better than economic growth – has seen the least progress. The gap between wage and GDP growth is larger than ever. Migrant workers still experience slower wage growth, and government spending on social welfare as a percentage of GDP has declined from 2015 levels. This was not for lack of effort. The government relaxed household registration (hukou) restrictions in mid-size cities. Beijing is making progress on pension fund centralization, expanding health insurance coverage, and raising social security contribution requirements from state-owned enterprises. Beijing assumed some welfare spending obligations from local governments and pushed the bureaucracy to spend more efficiently. But all these efforts have failed to increase worker compensation, job security and protections, and shared welfare.

Beijing remains far from realizing its 2013 state-owned enterprise (SOE) reform goals. SOEs were to be kept in “key and pillar” industries but removed from normal “commercial” sectors of the economy. Restructuring SOEs to ensure they operate efficiently was a goal, as was increasing their contributions to the social safety net. Actions taken so far have diluted state shareholding in a number of SOEs, reduced SOE financial leverage, linked SOE employee salaries to productivity, and forced SOEs to transfer 10% of state equity to social security funds. However, SOE presence across industries has barely changed, their efficiency has not improved, and more than 70% of the dividends they pay were reinvested back into SOE themselves, not used for social spending.

Land reform never got off the ground. While the 2013 Third Plenum promised to allow rural residents to sell their land through markets, authorities have only piloted this reform in 33 counties, accounting for just 0.1% of China’s total rural nonagricultural land. These pilots concluded with a modest revision of the Land Management Law last year, which removed the main legal obstacles for transferring rural land in the urban market but reinforced the strong governmental role. Beijing even delegated more power to provincial governments to speed up the urban land-use approval process in 2020, which may give them more room to profit from land sales at the expense of rural residents.

These reform failures share a common theme: China’s financial and economic institutions at this stage are too weak to overpower politically entrenched interests. Fiscal imbalances constrain labor reforms, and despite progress on the revenue side, local governments are still overburdened by unfunded spending mandates imposed by the center. Changing local government incentives is the only way to redirect spending to China’s workforce. SOE reforms have failed because SOEs lack incentives to leave commercial industries to more competitive private firms. On land reform, there is no sign that Beijing is prepared to unleash rural households, and any attempt to do so would face strong resistance from local governments that have become more reliant on land sales than they were five years ago. These problems are systemic, not individual.

Today: 2Q2020 Dashboard Indicators

The eight years from 2013 to 2020 have been tumultuous. Xi Jinping did not so much avoid market reform as retreat in the face of instability. The important question is not whether China established a record of reform over the past decade, but whether the lessons it learned trying are being applied today. Crises present a chance to push ahead with difficult changes. The COVID-19 pandemic presented such an opportunity. The virus lockdown offered a compelling reason to adjust policy, while the strength of the current recovery presents an opening to build momentum. With reform promises behind schedule and potential growth slowing, proof of market-friendly intentions could convince foreign and private firms to remain engaged.

But despite a robust economic performance in the second half of 2020 that puts the United States to shame, Beijing is not using the moment to invigorate its policy agenda. On the contrary, it is signaling rising reliance on statist solutions. The role of SOEs is resurgent, and the dual circulation campaign emphasizes self-reliance over openness and a free, international market. Furthermore, the state’s response to the ANT Financial float, and the opening of an anti-monopoly case against it, sends a message that China’s party-state is intolerant of private firms becoming too influential.
Each quarter we have looked at these policy dimensions through two lenses to reach a fair assessment that reasonable readers from outside and inside China could embrace: first a strict tally of outcomes using data alone and then a broader review of the policy landscape. By-the-numbers, the most negative story is now labor. The positive indicators are cross-border investment, fiscal, environment, and innovation.

In terms of policy pledges, the 2020 picture is bright despite COVID-19. Many reform initiatives were announced, responding to foreign pressure and domestic urgency. In April and May, guidelines once again promised “market allocation of factors of production” – land, labor, capital, and data. Beijing’s inclusion of data as a production factor is novel. The notion of a major government just now turning to the task of creating allocation mechanisms for everything that flows through the economy is ponderous. Many other ostensibly reform-oriented pronouncements were made this year as well. The new Shenzhen Comprehensive Reform pilot, introduced in October, sends a reform message to private investors but is little different from past efforts. The Party’s Guidelines for the 14th Five-Year Plan (FYP) released in early November for the next five-year period elevated “reform” as a priority, second only to growth among the 14th FYP’s primary goals (after being absent in 2015).

Financial sector opening has gotten the most credit for demonstrating reform this year. With a wider door to securities investment and high COVID-era yields, portfolio inflows surged in 2Q2020-3Q2020. With current conditions driving capital inflows enough to greater strengthen the renminbi, Beijing has an opportunity to open further, but risks of a financial reversal are accelerating too, and reform could bring more pain than Beijing can tolerate.

The pattern of statist signals overshadowing market messages is evident today, as it has been since 2013. The SOEs are the firms stepping up to support recovery. Their footprint remains in commercial sectors where state influence was to be rolled back. In September, the Party and State Council jointly issued Opinions on strengthening “United Front Work” to bolster Party influence over private businesses. The focus has shifted from reducing state presence to making it more efficient and “market economy like.” Ideology is increasingly broadcast into the private sector. The last-minute intervention in the listing of Ant Financial reveals the primitive state of financial maturation. Foreign demand for high-yield Chinese debt is elevated, but this is not the sort of moderate-risk value proposition that will attract long-term investment at scale. We save for last the major new policy design that emerged two quarters ago: the dual circulation strategy. Should this be classed as positive or negative for reform? Like many signature Chinese economic policy campaigns, the dual circulation strategy has become a Rorschach test for commentators.

The concept involves driving growth momentum through domestic demand, domesticized supply chains, and indigenous innovation, with both “external circulation” (accessing global demand and foreign capital and technology) and “internal circulation” (domestic demand and domestically developed technology). Engineering such a shift in sources of growth is sure to be difficult, and despite the rhetorical importance the campaign has been given by leaders as an elixir to China’s challenges, it has not been well defined. So far, it is impossible for economists to say how it will play out. On balance, its core organizing principle appears to be national self-reliance, rather than a robust re-commitment to the next generation of market-based reforms.

Tomorrow: Systemic Convergence or Divergence?

Some believe China’s leaders do not have economic reform in their DNA, and that World Trade Organization accession and the commitments like the 2013 Sixty Decisions were smokescreens. If nothing else, our Dashboard experiment has shown this to be wrong. Beijing has come up short on its reform pledges, true, but in a number of areas it has tried.

This seemingly modest assertion is crucial to the future. If China has tried to shift economic policy in a market-oriented direction in the past, it may well have motive and opportunity to do so again tomorrow. What compelled China to reform in the past was the historical evidence that illiberal, politicized economies have stagnated and become less productive, tied with the boldness of its leaders in trying to avoid that dead end. The historical record remains, especially when one takes a hard look at the recent and present record of China’s performance and acknowledges the likelihood of growth overstatement, risk underestimation and the enduring role of the state rather than the market.

In our 2015-2020 Dashboard, we measured China against its self-stated goal of moving to decisive markets. Since the premise of economic convergence is not on the table at present in Beijing or, increasingly, in open market economy capitals, the yardstick going forward will not be Beijing’s stated goals, but the gap between China and the norms of market-orientation as defined by the market economies themselves. There will very likely be points of
convergence and points of divergence. China appears committed to opening to global capital inflows despite its resurgent preference for state planning.

Finally, it will be crucial to consider that we do not have to be like-minded in our economic systems to recognize we are in the same global boat, and on many matters, we must work together closely regardless of our systemic differences. The great majority of products for which China or the United States has clear comparative advantage are not strategically concerning to either. This is a point well worth remembering as policymakers contemplating decoupling (in the United States) or dual circulation (in China) consider closing doors on engagement.
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 maintain our slightly negative assessment of China’s competition policy reform this quarter. The data are mixed and some policies are encouraging, but the political environment is concerning.

- In 2Q2020, Beijing reviewed fewer foreign-involved mergers and more domestic mergers than in 1Q2020, but as a share of total deals foreign firms are still disproportionately scrutinized. New business registrations have recovered to pre-pandemic levels, but large firms have continued to use their market power at the expense of smaller peers.

- U.S.-China tensions overshadowed efforts to improve competition through judicial system reform. Achieving equal treatment of foreign firms appears increasingly unlikely as China’s leaders emphasize self-reliance in response to an unfavorable external environment.
This Quarter’s Numbers

Authorities reviewed fewer foreign-involved mergers and more domestic deals in 2Q2020 but still disproportionately targeted foreign firms for review as a share of total deals. The State Administration for Market Regulation (SAMR) reviewed 40 foreign-involved mergers, 18% fewer than in 1Q2020, and 35 domestic mergers, 35% more than 1Q2020. Skewing these comparisons, however, was the breakdown of deals in the quarter: the number of foreign-involved transactions fell slightly while domestic deals nearly doubled. Overall, the share of foreign-involved mergers subject to scrutiny decreased to 27% in 2Q2020 from 32% in 1Q2020 but remains far higher than domestic reviews at 6%.

China’s domestic business environment continues to show signs of recovery from the pandemic. In September, the SAMR reported that new business registrations in China averaged 21,000 per day in the first seven months of 2020. Third-party data show a similar number, with a sharp decline in 1Q2020 and a strong rebound in 2Q2020. The SAMR also reported that on a net basis, 11,000 new businesses were registered per day in the period, implying 10,000 were dissolved per day. This number may look impressive, but it is only 2.5% higher than the 2019 average— and more troubling it is not significant considering the impact of the pandemic.

Looking ahead, large firms may continue to squeeze out smaller rivals. The pricing power of large listed companies, especially private firms, surpassed the OECD average in the quarter. This could be seen as a positive sign in pre-COVID circumstances, indicating that private firms are charging enough for their goods and services to recover a reasonable profit. However, the increase during the pandemic implies that large firms abused their market power against smaller competitors, customers, and vendors, suggesting a less competitive environment.

Supplemental 1: Results of Merger Reviews

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

Supplemental 2: Judicial System Transparency

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

Number of court cases on competition and intellectual property disclosed

Number of court cases on competition and intellectual property
Supplemental 3: Market Entry and Exit

Number of new domestic companies registered each quarter
Number of domestic companies dissolved each quarter

Source: State Administration for Market Regulation, Rhodium Group.

Supplemental 4: Pricing Power Index

Percentage

Average price markups of OECD companies
Average price markups of Chinese listed non-SOEs
Average price markups of Chinese listed companies
Average price markups of Chinese listed SOEs

Source: Bloomberg, Rhodium Group.

Policy Analysis

Beijing’s attempts to improve the business environment in China, which focused on strengthening the judicial system, were overshadowed by rising political tensions with the United States. On September 4, SAMR released draft trade secret protection rules (a follow-up to the revised Anti-Unfair Competition Law in 2017) for public comment. On September 25, the Supreme Court promised to improve judicial services for foreign businesses to support cross-border trade, investment, and intellectual property protection. On October 17, the National People’s Congress Standing Committee passed the revised Patent Law, which significantly increased penalties for violations. A lack of meaningful penalties in the previous version of the law had led to continued patent infringements.

Amid these improvements, Beijing also took several steps that have led to a chill in the business environment for foreign firms. These actions raised doubts about whether judicial system and regulatory regime reforms would lead to a level playing field. Most notably, published rules on “unreliable entities” (September 19), released after the United States moved to ban TikTok and WeChat, raised the specter of more politicized competition conditions.

Final Dashboard Assessment

Overall, China’s progress on competition policy reform since the 2013 Third Plenum is mixed. It has delivered some improvements; however, on balance, they do not go far enough to convince foreign firms that they will receive fair and equal treatment in China. Beijing has simplified the process for registering new businesses, a move that has led to a doubling of such registrations over a five-year period. It has also made it easier for firms to exit the market and file bankruptcy claims. This led the World Bank to upgrade China’s ease of doing business ranking in 2019 (see Spring 2020 Edition). Beijing forced local governments to amend more than 20,000 anti-competitive rules in 2018 alone (see Spring 2019 Edition), revised the Anti-Unfair Competition Law (see Spring 2018 Edition), and is in the process of revising the Antitrust Law (see Winter 2020 Edition).

But the core questions remain unanswered: will China treat foreign and domestic firms equally, and will China use its competition laws to actually promote competition or to make things difficult for foreign firms? Beijing has promised equal treatment, but our primary indicator shows that foreign firms still face more scrutiny than domestic peers in merger reviews and face higher barriers in China’s court system. Beijing is likely to continue to assess foreign firms (especially U.S. firms) as presenting a special economic competition risk, given the tensions of the Trump years. As the government doubles down on self-sufficiency through initiatives like “dual circulation,” foreign tensions may well rise further. This depends on the pro-competitive spirit with which China pursues policy, not just the letter of the rules.
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

- We upgrade our assessment of reform in cross-border investment as capital flows increased in both directions in 2Q2020.

- China attracted stronger portfolio inflows in 2Q2020 because its economy has recovered faster than expected from the effects of COVID-19 lockdowns, with the lure of positive real interest rates and yields increasing global appetite for Chinese assets, despite a recent wave of defaults in China’s corporate bond market.

- Authorities have made more promises of capital account liberalization, and conditions are now favorable for liberalizing outbound flows. However, this is a reform objective that has not yet been met.

This Quarter’s Numbers

Investment openness improved this quarter. In 2Q2020, cross-border capital flows increased in both directions and as a proportion of China’s economy, compared with the prior quarter. Our primary indicator (External Financial Liberalization) shows that the ratio of capital flows to GDP rose to 5.61% in 2Q2020 from 4.80% in 1Q2020, the third consecutive quarterly increase. However, this is partly a result of the contraction in China’s GDP earlier this year. The ratio remains far below those of advanced economies.
Capital flows into China rose in 2Q2020 as financial markets stabilized and as the Federal Reserve eased US dollar funding conditions in April. In the first quarter, private investors reacted to the COVID shock by withdrawing investment from China, particularly from the equity market, and seeking safer havens abroad. In 2Q2020, private inflows returned to China’s bond and equity markets. As a result, China posted one of its largest portfolio securities inflows in history at $42.4 billion (see Net Capital Flows). (Strong inflows into the bond market continued in 3Q2020, but stock market flows have since reversed.)

Although the small $19.1 billion increase in China’s foreign exchange reserves in 2Q2020 suggests the People’s Bank of China (PBOC) did not intervene significantly to manage the exchange rate, it is likely that there was an indirect intervention to limit the currency’s appreciation (see FX Reserves). The PBOC can do this by instructing state banks to purchase foreign exchange on its behalf. In the second quarter, China was facing strong inflows from trade surpluses and portfolio flows, which would have pressured the RMB to appreciate and kept capital outflows minimal. The reported high level of capital outflows in 2Q2020 is not consistent with minimal foreign exchange intervention. Hidden intervention of this kind is a backward step for exchange rate reform, though it may be temporary, as the PBOC has appeared to stop intervening in 3Q2020.

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

Supplemental 1: Net Capital Flows
USD billion

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

Supplemental 3: Currency Intervention
USD billion

Source: State Administration of Foreign Exchange, Rhodium Group.

China Dashboard Winter 2021
**Supplemental 4: Foreign Appetite and Market Access**

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

Coupled with relatively favorable conditions in light of the rest of the world still reeling from the COVID-19 pandemic, China’s past opening efforts have succeeded in expanding cross-border capital flows, particularly for portfolio inflows. The rise in inflows has created a window of opportunity for regulators to do what they have not done so far — liberalize channels for capital outflows. The first step taken in early October was to reduce the reserve requirement on foreign exchange forward transactions to zero, reversing an action taken in August 2018 when the RMB was under pressure to depreciate. Following this, the State Administration of Foreign Exchange (SAFE) also expanded quotas for outbound portfolio investment by $10 billion.

In addition, financial technocrats are sounding more positive about capital account liberalization and exchange rate liberalization overall. PBOC Governor Yi Gang said in late October that the regulator’s main job was to “reduce restrictions on the cross-border use of the currency, and let it take its own course.” After five years of restricting outbound capital flows due to concerns about the possibility of losing control of China’s currency, this is a notable shift in approach and a positive signal for investment opening.

The exchange rate fluctuated more in 3Q2020, with authorities allowing market forces more sway. The RMB appreciated from 7.06 per dollar at the end of 2Q2020 to around 6.60 per dollar by early November, a sharp appreciation by historical standards. At the same time, however, there are indications that the PBOC is trying to manage the currency indirectly by pressuring state banks to purchase US dollars on the central bank’s behalf, which should tend to weaken the value of China’s currency (see above).

**Supplemental 5: Globalization of China’s Currency**

Chinese yuan (RMB) usage in global transactions, percent

Policy Analysis

Authorities took small steps to liberalize foreign direct investment (FDI) inflows and talked seriously about loosening controls on outbound investment.

Following the release of a shorter FDI Negative List and draft measures reducing administrative barriers to foreign acquisitions of Chinese companies in June, China announced new steps to improve foreign investor access. On October 11, the State Council unveiled a comprehensive 2020-2025 pilot plan for reforms in Shenzhen, the southern special zone city paired with Hong Kong. The plan aims to “optimize the business environment” by promoting openness and fair competition. Shenzhen will further relax restrictions in energy, telecoms, public service, transport, and education, while opening up the financial services and shipping industries. This is all well and good, but why does all of this still need doing – on just a “pilot” basis no less – 42 years into the “reform and opening” era?
today: in fact, years of deferral has made them more difficult. The exchange rate regime is barely altered: PBOC says market forces Looking back, Beijing has made progress in inbound FDI reform since 2013. China moved from an approval-based system to a more liberal negative list-based approach and has gradually reduced the number of restricted sectors. After years of wavering, Beijing advanced outbound capital account reforms modestly by reducing quotas, but that does not mean much until it is symmetric, and outbound financial account opening is introduced in the same degree.

China's present stability relative to the world economy presents an opportunity to make good on 2013 pledges to liberalize the capital account and cross-border investment flows. But the fundamental reforms that have proven too challenging the past seven years are no less daunting today: in fact, years of deferral have made them more difficult. The exchange rate regime is barely altered: PBOC says market forces will play a greater role, but the system is little different from how it was after the initial exchange rate reforms of July 2005. Concerns that the currency may move too fast — in either direction — mean that the central bank steps in to control movements, directly and indirectly. Market participants watch Beijing's political priorities more than they do market forces. This has constrained cross-border investment policy liberalization in general since 2013 and will continue to limit potential until it is changed.
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 reform score remains neutral, as pollution rebounded but renewable resource utilization increased.

- China’s environmental pollution returned to pre-COVID levels in 2Q2020 as economic activity resumed following 1Q2020 lockdowns. Seasonally adjusted air and water pollution levels were flat or only slightly improved year-on-year.

- To help China get past the pandemic, local officials are relaxing environmental restrictions and expanding infrastructure and coal stimulus. By contrast, central authorities have announced ambitious policies to combat climate change. President Xi Jinping’s pledge to make China carbon neutral before 2060 is encouraging but difficult to square with center-local tensions over environmental enforcement, China’s continued heavy reliance on coal power, and its financing of new coal-fired power plants around the world.

**This Quarter’s Numbers**

After improving in 1Q2020 as economic activity in China ground to a halt due to COVID-related lockdowns, all of our environmental indicators deteriorated in 2Q2020, returning to pre-COVID levels. Air and water pollution increased (quarter-on-quarter), though they remain slightly lower than in 2Q2019. Air pollution conditions were exacerbated by the larger-than-usual share of coal power in electricity generation in April and May, as well as carbon-intensive infrastructure stimulus from local governments (see **Policy Analysis** below). A relaxation of curfews leading to higher automobile traffic also contributed to resurgent emissions.

Though pollution worsened, renewable energy sources and technologies were put into expanded use. Wind curtailment—the wind energy wasted because it could not be absorbed or transmitted to the grid—decreased back to its pre-crisis levels (around 3%). In addition, **Sales of New Energy Vehicles (NEVs)** as a share of total auto sales rebounded after a historic collapse in 1Q2020, part of a broader recovery in the automotive sector as showrooms opened and production (especially of commercial vehicles and trucks) rebounded. Second-quarter NEV sales were lower than 2Q2019, but the 12% drop was much smaller than the 62% plunge recorded in 1Q2020. Stronger than expected results from Tesla and Nio, as well as Volkswagen’s announcement in May that it would invest in EV production, all bode well for NEV adoption.

**Policy Analysis**

**Primary Indicator: Water and Air Quality Trends**

*Index, Nov 2014 = 100*

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**Supplemental 1: Wind Energy Curtailment**

*Terawatt hours (TWh)*

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Source: China Electricity Council, Rhodium Group.

**Supplemental 2: Sale of New Energy Vehicles**

*Percent*

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Source: China Association of Automobile Manufacturers, Rhodium Group.
Supplemental 3: Overall Electricity Generation

Billion Kilowatt-Hours


Supplemental 4: Non-Fossil Electricity Generation

Index


**Policy Analysis**

Beijing has not resolved the central tension in its environmental policy: balancing pollution-intensive short-term support for the economy with the long-term goal of being green. The contradictions were evident in June as provinces approved the most new coal power capacity in five years, while central agencies ordered a focus on clean energy and improved renewable grid capacity.

As we predicted in the Summer 2020 Edition, the pressure to support economic recovery led China to fudge a key environmental target. In May, Premier Li Keqiang announced that China would continue to reduce energy consumption per unit of GDP—emissions intensity—but declined to offer a specific target as China had done since 2014. Economic growth is taking precedence over meeting environmental targets at this time.

While China is dropping short-term targets, it is making ambitious long-term commitments. In September, President Xi Jinping pledged that the country would become carbon neutral before 2060 and reach peak carbon dioxide emissions by 2030. No ministry has yet provided specifics on how these goals will be achieved. China's pledge is potentially game changing, but attaining the 2060 goal will require significant changes to the country's energy mix.

**Final Dashboard Assessment**

Looking back, China's 2013 environmental reform plans were ambitious. They included stepping up enforcement; initiating new pollution control, waste treatment, and environmental cleanup rules; taxing greenhouse gas emissions; and shrinking carbon-intensive industries such as coal. The implementation of these plans has been mixed. China reined in chemical and toxic material pollution following several large-scale industrial accidents (see Summer 2019/Spring 2019 Editions). Administrative rule changes have made officials more accountable for pollution. China has also integrated environmental scores into government performance evaluations.

Although air and water pollution levels do not yet meet international standards, average quarterly particulate matter (PM 2.5) pollution has fallen by nearly 40% since 2014, and water pollution has been reduced by 15%. Renewable energy and green automotive technology have expanded, and NEVs and wind power have become less expensive, more widespread, and more efficient in a short period of time. The availability and quality of China's environmental data have generally improved, although the whole framework of China's macroeconomic data has increasingly come under greater scrutiny due to multiple statistical inconsistencies.

To truly achieve the goal of environmental sustainability, China will need to make absolute (not just relative) reductions in coal power capacity, further restrict gasoline-powered cars, and break its reliance on pollution-intensive activity for growth. China has met its Third Plenum goals on the share of renewables and coal in the energy mix; however, absolute coal consumption continues to grow, and air and water pollution remain heavy in specific regions. The challenge is not only to meet China's global commitments on air pollution but also to ensure that no region is left behind at home.

The next five years of China's environmental policy will be crucial. Some laws have yet to be fully implemented, like the carbon tax and cap-and-trade system. But the contents of the Communist Party's 14th Five Year Plan, covering 2021 to 2025 and coming out in March 2021, will be most important. The danger is that it will be more of the same, with no absolute emissions targets and limited (if any) commitments to reduce coal capacity.
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, and inclusions in two other major bond indices have followed.

Methodology

To gauge the state of financial system reform, we construct a quarterly incremental capital output ratio (QICOR) 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 maintain our slightly negative assessment from the previous quarter, as Beijing is still instructing the banking system to support distressed borrowers to combat the post-COVID economic downturn. Even if necessary in the short-term, this delays progress toward market-driven allocation of credit.

- Not surprisingly, given the COVID-19 crisis, our indicator shows a significant decline in financial system efficiency in 2Q2020. More credit has been needed to forestall a sharper slowdown.

- There are some signs of progress in reducing over-reliance on banks for so much financing and better market pricing of credit risk: corporate bond issuance increased even as defaults are rising, and foreign purchases of China’s bonds went up.

This Quarter’s Numbers

Financial system efficiency deteriorated in 2Q2020. Our primary indicator, the Quarterly Incremental Capital Output Ratio (QICOR), rose sharply, to a level way above international norms. After the shock of COVID-19, China is still piling on more financing and generating even less growth.
Primary Indicator: Incremental Capital Output Ratio
4qma, ratio value

Supplemental 1: Growth in Credit
Percent

Supplemental 2: Direct Financing Ratio
4qma, percent

(Methodology note: Because the contraction in China’s GDP due to COVID-19 produced a faulty reading in the QoCQR in 1Q2020, we used zero GDP growth instead. This approach understated the fall in China’s financial system efficiency in 1Q2020. Now that the economy has returned to positive growth, we revert to using the official 3.2% GDP growth rate this quarter.)

In response to the impact of COVID-19, Beijing encouraged credit growth and urged banks to give borrowers (particularly small and medium enterprises) flexibility in repaying debt. Growth in Credit picked up to 11.5% year-on-year (yoy) in 2Q2020, compared with 10.7% in 1Q2020. That has prevented a sharper economic decline, but at the cost of deteriorating asset quality at banks. As deteriorating assets are recognized on balance sheets, banks will be unable to grow credit at the current pace.

New credit has been driven by government and corporate bond issuance, rather than a surge in new loans, which only expanded by 12.3% in 2Q2020, slightly slower than in 1Q2020. Direct financing from the bond market has improved because of the overall decline in interest rates since the beginning of the year. The Direct Financing Ratio rose to 20.2% in 2Q2020, its highest level since 1Q2017.

Money market interest rates, or the cost of borrowing for financial institutions, fell very sharply early in 2Q2020 due to central bank easing. The interest rates for bank-to-bank financing and for nonbank financial institutions declined (see Interbank Lending Rates). However, in May and June, rates stabilized and then rebounded, as the People’s Bank of China (PBOC) tried to squeeze out frenzied market speculation. The effort to clamp down on speculative trades should be viewed as a positive signal for financial reform.

While foreign institutional investors initially moved money out of China as the COVID-19 outbreak hit, by the second quarter, investment in Chinese stocks and bonds rebounded. Nevertheless, foreign investors’ share of total bondholding only rose from 2.2% to 2.3% (see Foreign Held Bonds). The increase is modest due to the large expansion of overall corporate and government bond issuance. Foreign inflows should continue to rise, given the recent addition of China’s securities to the FTSE Russell index.
Beijing lowered border investment barriers, a necessary step for inclusion in the FTSE Russell index. Specific improvements made in September included extending trading hours in China’s interbank market to accommodate European investors, easing capital repatriation restrictions, and giving foreign investors in the interbank market access to the exchange-traded bond market. More corporate bonds trade in the exchange-traded market, giving foreign investors access beyond government and policy bank bonds.

Beijing continues to focus on shadow financing risks, particularly in the property sector. New PBOC and Ministry of Housing and Rural Development (MOHURD) regulations limit property developers’ balance sheet growth, starting with larger developers. These are meaningful restrictions on shadow financing because developers are major borrowers from nonbank institutions. With the PBOC’s continued squeeze on arbitrage trading, this shows commitment to reducing shadow banking risks.

The major setback for financial reform in China right now is that the largest financial institutions — commercial banks — are increasingly acting as state policy tools rather than as profit-oriented institutions. This is a step backward after previous efforts to encourage market-driven lending. Smaller rural commercial banks are struggling with nonperforming loans and raising new capital, which prevents them from extending old loans or offering new loans to troubled small and medium enterprises (SMEs). Authorities have guided banks to extend forbearance for distressed borrowers until March 2021 and may extend this further. This is a big negative for the financial reform outlook.

In addition, the recent postponement of Ant Financial’s initial public offering has rekindled concerns about sudden state intervention in the private sector. The move does represent a setback for financial reform but also reflects legitimate regulatory issues in China’s digital economy, including the boundaries between state and market influence over credit pricing, the use of consumer data, and anticompetitive practices in financial technologies. The state is now reasserting some of the boundaries that private firms such as Ant had successfully broken down.

As credit risks build, leaders face limits on using administrative tools to manage financial stress. Default risks are rising, particularly in corporate bond markets: even bonds issued by local government financing vehicles are defaulting, and investors are questioning local governments’ commitment and capacity to repay their debts. That is actually positive for reform because it means
bad choices are punished, but Beijing faces a delicate balancing act in enforcing market discipline while preventing a broader pullback in lending.

**Final Dashboard Assessment**

China’s 2013 reform agenda pledged more market-driven allocation of resources and pricing of capital, a more flexible exchange rate regime, and openness to foreign investors. Since then, system-wide financial efficiency has deteriorated. Too much credit is allocated to inefficient state-owned enterprises and local government financing vehicles, whose debt burdens rise relative to the size of the economy.

The interest rate regime has changed fundamentally since 2013, but administrative controls remain in one form or another, limiting the opportunity for financial institutions to price capital. Exchange rate liberalization has also stepped backward: there is considerable evidence of PBOC intervention to manage swings in the currency, and political considerations continue to heavily influence rate movements.

China has made the most progress in two areas: opening to foreign portfolio investors and controlling shadow banks and informal financing channel risks. Some of this progress has been reversed since the COVID-19 outbreak. Fears of capital control reimposition remain an obstacle to larger foreign inflows, and overall foreign investment has barely expanded as a proportion of China’s market.
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 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 and remains slightly positive this quarter. Limited spending due to the pandemic and continued bond issuance stabilized the fiscal gap.

- Transfers from the central government supplemented falling tax revenue for local governments.

- As China recovers from COVID-19, lagging infrastructure spending will pick up, but bond revenue will decrease, pressuring already indebted local governments.

This Quarter’s Numbers

In 2Q2020, local governments continued to spend more than they took in, but the gap has narrowed slightly for the third consecutive quarter. The augmented Local Expenditure-to-Revenue Ratio stood at 127.3% in 2Q2020, compared with 128.5% in 1Q2020 and 128.9% in 4Q2019. Both revenue and expenditure rose from deep declines in the first quarter as China eased lockdown measures: the revenue rebound was greater than spending.

This improvement will be short lived: the expenditure-to-revenue gap will widen as local government bond issuance slows after October. Moreover, local spending delayed by COVID-19 will accelerate. As of August, local authorities
had spent just 60.6% of the full-year budget, compared with an average of 67.4% the past three years. Spending by local government funds, which is used to finance infrastructure investment projects, was only half of the full-year budget and below historical levels. As long as the central government puts the burden of spending for economic growth on local officials, the incentives impeding fiscal reform will dominate.

Spending on social services as a share of all government outlays expanded modestly this quarter in response to COVID-19 (see Government Social Expenditures). Increased social security spending is being used to help those unemployed because of the pandemic, while local governments have stepped up healthcare expenditure to contain the virus.

### Primary Indicator: Local Governments Expenditure-to-Revenue Ratio

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<td>1Q2020</td>
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### Supplemental 1: Sources of Local Government Financing

- LGFV Bond Net Issuance
- Local Government New Financing Bond
- Fund Revenue
- Transfer Payment and Tax Refund
- Local Government Revenue


### Supplemental 2: Fiscal Deficit Measures

- Augmented Deficit
- Official Deficit
- Official Deficit Target

Source: Ministry of Finance, Rhodium Group.

### Supplemental 3: Direct Taxation Ratio

- OECD
- China

Source: OECD, Ministry of Finance, Rhodium Group.

### Supplemental 4: Government Social Expenditure

- Environmental Protection
- Health and Family Planning
- Social Security
- Education

Source: Ministry of Finance, Rhodium Group.

**Policy Analysis**

Prior to COVID-19, the fiscal policy priority was local government deleveraging after years of funding unprofitable projects. The virus emergency shifted the focus to shoring up local infrastructure spending to avoid a more severe recession. In effect, the policy guidance went into reverse, and that is likely to drive more fiscal problems in the future. Whether the 2020 crisis justified such a decision will long be debated. China is envied for its...
present growth recovery, but the final judgment must reflect the impact on long-term sustainability.

Although back in accommodation mode, Beijing did not offer the sort of blockbuster leverage growth that captured the world’s attention in 2009-2010. That at least is positive for reform. Namely, authorities are requiring local infrastructure projects to generate enough returns to cover borrowing costs. But after many years of heavy spending, finding such projects is hard, and the pressure to put money to work quickly has been intense this year. New regulations strip industrial and high-tech zones of their fiscal independence, tightening budget oversight in an effort to curb debt buildup. Naturally, reducing debt risk will put a damper on growth.

Local governments will also soon have a new source of revenue: real estate investment trusts (REITs), through which they can securitize local highways, warehouses, utility services, or even telecommunication networks to raise cash. Since the National Development and Reform Commission (NDRC) and China Securities Regulatory Commission (CSRC) set forth guidelines in an April circular, several firms filed paperwork to issue REITs in 3Q2020. This is particularly important given that a recent wave of state-owned enterprise (SOE) defaults has damaged local governments’ creditability, making it more difficult for local governments and their financing vehicles to raise cash through bond issuance. In contrast, REIT cash flows are more transparent to investors and thus are easier to sell, making them a key source of future local government revenue.

**Final Dashboard Assessment**

Looking back, the primary fiscal goal of Beijing’s 2013 economic reform plan—narrowing the gap between local government spending and revenue—has barely advanced. Part of the equation is creating new sources of revenue, but local authorities still cannot grow revenue without exploiting land sales and are skimping on crucial expenditures in public goods. The long-discussed property tax, which would go a long way toward increasing local revenue and cooling property bubbles, never made it into law. Beijing took a small step forward in 2019 by allocating more consumption tax revenue to local governments, but the absence of bolder steps failed to change the overall picture. Localities have greater room for bond financing, which reduces reliance on risky and expensive informal funding channels, making local accounts more transparent. That is a step toward reform, but only if proceeds are used productively.

Less progress has been made on the other side of the ledger: cutting erroneous spending. Regulations did limit land and property-related construction starting in September 2019. However, Beijing’s decision to stimulate infrastructure spending after COVID-19 to spur economic growth is working against fiscal reform goals.

Success going forward must target not just closing the spending-revenue gap but also improving debt sustainability, which featured in the 5th Plenum Communiqué on the upcoming 14th Five Year Plan. Local government bonds will continue to be used to fill the fiscal gap and to finance existing debt as borrowing costs are high. However, local government debt is becoming increasingly difficult to manage, and defaults are on the rise. High-profile SOE defaults in late October will likely spread to local government financing vehicles (LGFVs) and accelerate, demonstrating how unresolved debt problems continue to diminish the ability to raise funds and erode local government credibility. REITs are one solution, but more fundamentally, Beijing needs to reduce local spending byshouldering more of the spending burden at the central level and by introducing more private capital into the infrastructure sector.
Innovation

The Story So Far

Innovation drives economic potential, especially as incomes rise and workforce and investment growth moderate. Promoting innovation is more difficult than cutting interest rates or approving projects. Innovativeness within an economy is an outcome reflecting education, intellectual property rights (IPR) protection, marketplace competition, and myriad other factors. Some countries have formal innovation policies and some do not, and opinions vary on whether government intervention helps or hurts in the long run. Many Chinese, Japanese, and other innovation policies have fallen short in the past, while centers of invention in the United States such as Silicon Valley, Boston, and Austin have succeeded with limited government policy support. In other cases, innovation interventions have helped, at least for a while.

- The 2013 Third Plenum released a series of decisions aiming at improving the innovation environment in China. Compared with previous innovation strategies, the Third Plenum placed a greater emphasis on market forces, calling for “market-based technology innovation mechanisms” while announcing that the “market is to play a key part in determining innovation programs and allocation of funds and assessing results, and administrative dominance is to be abolished.”

- In May 2015, China officially launched Made in China 2025 (MC2025), a 10-year strategic plan for achieving new levels of innovation in emerging sectors. The MC2025 agenda diluted the Third Plenum’s emphasis on market mechanisms with more elements of central planning. The blueprint set performance targets for 10 key industries in the proportions of domestic content and domestic control of intellectual property. An associated implementation road map document laid out specific benchmarks for global market share to be achieved by Chinese firms in emerging sectors, generating significant international backlash.

- Recognizing the prevalence of subsidy abuses and excess capacity related to its industrial policy programs, Beijing announced in December 2017 that it would gradually phase out some subsidy programs, such as for photovoltaic power generation and new energy vehicles (NEV).

- In March 2018, the U.S. Trade Representative’s Section 301 Report concluded that key parts of China’s technology push, including MC2025, were “unreasonable or discriminatory and burden or restrict U.S. commerce.” The United States then imposed trade tariffs on $250 billion worth of Chinese imports over the course of 2018, including some products related to MC2025 and many that were not.

- In May 2019, the U.S. Trade Representative raised tariffs from 10% to 25% on nearly $200 billion of goods from China and started to review tariffs on the remainder of imports from China. Beijing retaliated by raising tariff rates on some imports from the United States. The U.S. Department of Commerce also added several Chinese high-tech manufacturers to its “Entity List”—a list of companies believed to present national security risks to the United States—effectively restricting those firms’ access to U.S. exports.

Methodology

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

Quarterly Assessment and Outlook

- We upgrade our assessment of China’s innovation reform progress from neutral to slightly positive this quarter. Innovative industries contributed more to China’s economy in 2Q2020 than in the previous quarter.

- Four out of the seven innovative industries we track grew above the industrial sector average in 2Q2020, while the other three underperformed.

- China imposed new restrictions on homegrown technology exports in August and December, which could hinder innovation by limiting the business scope of Chinese companies operating overseas and foreign-invested firms in China.
This Quarter’s Numbers

Our measure of innovative activity shows a rebound in 2Q2020: innovation played a bigger role in China’s industrial sector after shrinking under COVID-19 in 1Q2020 (see Innovative Industry Share in Industrial Value-Added [IVA]). Innovative industries accounted for 33.97% of total industrial sector value-added, a small increase from 33.59% in 1Q2020 but still significant for a quarterly change. The industries now have more weight in China’s economy than they do in the United States (33.52% as of 2017), but the European Union leads both (36.44% as of 2016).

Some innovative industries witnessed robust growth while others lagged. Special purpose equipment, electric machinery, communication equipment and electronics, as well as instruments and meters expanded faster than the industrial sector average in 2Q2020, while universal equipment, autos, and ex-auto transportation equipment underperformed (see Industrial Value-Added Growth Rates for Specific Innovative Industries). This divergence is likely temporary: preliminary data show that auto and universal equipment have rebounded in 3Q2020.

After several quarters of contraction, two-way IP flows increased in 2Q2020, with imports rising 5% year-on-year (yoy) (see Intellectual Property Flows). This suggests China is purchasing (and paying for) more foreign copyrights, proprietary manufacturing processes, and/or computer and software-related licensing than at this time last year. Increased IP trade can suggest stronger IPR enforcement in China, but this quarter’s increase may reflect surging semiconductor imports as Chinese firms continue to stockpile ahead of tighter U.S. export controls.

**Primary Indicator: Innovation Industry Share in Industrial Value-added**

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**Policy Analysis**

China started to modify innovation policies amid growing political tension. Beijing has stopped using explicit market shares and growth targets to guide industrial policy and...
pledged to let the market play a bigger role in supporting innovation, while intensifying its focus on state-engineered technology self-reliance.

Beijing tightened technology export controls in apparent retaliation to U.S. measures. On August 28, China’s Ministry of Commerce (MOFCOM) and Ministry of Science and Technology (MOST) published a revised version of the Catalogue of Technologies Prohibited or Restricted from Export (Catalogue). MOFCOM added 23 restricted technologies (including drone technology, 3D printing, and a whole range of cyber technologies), removed 9, and modified 14. The addition of “data analysis-based personalized information recommendation technology” to the export control list effectively prohibited the video-sharing app TikTok from being sold to U.S. companies without Beijing’s approval, in reaction to U.S. sanctions.

More importantly, on October 17, the National People’s Congress Standing Committee passed the Export Control Law, which went into effect on December 1, 2020. The ambiguous “deemed export” provision could prevent multinational companies from transferring sensitive technology between parts of the same company, even if the transaction is not cross border. The law also applies to reexports of sensitive China-origin content outside of China’s borders, expanding and tightening its technology export control regime.

Other policies offered positive signals on the state-market balance in promoting innovation. The Shenzhen Comprehensive Reform Program released by the State Council on October 11 promised big reforms for the country’s innovation base. One section of the program focuses on the “marketization” of technology and data as fundamental factors of production or inputs needed to produce the economy’s output. This means Shenzhen can experiment with policies that give the market, rather than the government, more say in what innovation opportunities to pursue and how research and development resources should be allocated. Specific policies and plans for nationwide expansion have not yet been released.

**Final Dashboard Assessment**

Innovation is the policy area that has shown the most consistent improvement since the inception of the China Dashboard project, demonstrating China’s commitment to dedicating political and economic resources to improving the performance of the technology sector, and innovation activities in general. However, looking back at the 2013 reform agenda, the China Dashboard shows innovation policies have deviated from Beijing’s commitment to make the market the driving force of innovation, as progress was dependent on government activism. Intellectual property protection and enforcement improvements helped level the playing field for private and foreign firms, but there is skepticism about whether these improvements will last once campaign-style enforcement loses political momentum. In industrial policy, Beijing reinforced the state’s dominant role in guiding innovation. Made in China 2025 drove significant investment and rapid growth but at the cost of low investment efficiency, overcapacity, and market discrimination. An honest assessment of the program is lacking, and the government instead tried to downplay it without materially changing the substance in response to international pushback.

But state dominance over innovation policy has boosted innovative activity in China. Since our first Dashboard update in fall 2017, the innovative industry share has risen from 31.80% to 33.97%—a material increase in a short period of time. Growth has been consistent; innovation levels rose in 11 out of the 13 review periods in our records. By our measure, China has already caught up with the United States in terms of broadly defined innovation industries (though it is far from the cutting edge) and at this rate would reach parity with the EU within two to three years. While our indicators speak to the trend, they do not judge the means. China’s high-tech ambitions might well be better served by allowing more competition and eliminating market distortions.

China’s innovation policy is likely to include a mix of market and state drivers in the coming years. The communique of the Party’s Fifth Plenum, released on October 29, again identified innovation as the most important growth engine for China’s economy for the next 15 years. The blueprint establishes technological self-reliance as a major pillar in the new “dual circulation” policy, in response to declining growth potential at home and rising hostilities abroad. However, there is no guarantee that government-engineered innovation outcomes will be more successful than encouraging and enabling market competition. The Fifth Plenum communique eliminated mention of Made in China 2025 by setting market share and growth targets for domestic companies in 10 priority industries. The new plan shows various modifications but no substantial change of directions. The increasingly hostile technological competition between China and other advanced economies has become a justification for government intervention in the innovation ecosystem, even if it is clearly suboptimal on economic terms.
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 labor reform assessment in 2Q2020. Although China’s economy rebounded statistically, job opportunities and social benefits declined.

- Wages for migrant workers continued to fall sharply, while citizens with permanent urban and rural residency status were less affected, increasing the gap.

- Beijing is trying to support workers by promoting new digitally enabled economic activities and more flexible employment; however, fiscal constraints continue to limit the effective implementation of these and other labor reform policies.

This Quarter’s Numbers

Labor reform indicators worsened in 2Q2020 despite China’s economic recovery, meaning workers have not been sharing in the growth rebound. Price-adjusted wages for migrant workers continued to fall, contracting by 9.2% year-on-year (yoy). Urban households saw wages fall by 0.2% yoy. Only rural households experienced wage growth that was faster than that of the economy, as demand for agricultural products remained high as the pandemic subsided. Altogether, price-adjusted wage growth was 60% lower than GDP growth, the largest gap since data became available in 2014.
Wages lagged GDP growth because job creation was weak, not because GDP growth was strong. China created only 3.3 million jobs in 2Q2020, an improvement from 2.3 million in 1Q2020 but still 19% below 2019 levels (see New Job Creation). The number of job openings per applicant fell across the country as companies delayed hiring due to the uncertain economic outlook (see Labor Demand-Supply Ratio). This is a vicious cycle: domestic demand is unlikely to recover until household incomes and consumer confidence rebound.

The Chinese government has been constrained from doing more to help. Social security and employment spending increased by 5% yoy, but that spending represented only 3.2% of GDP in the quarter, down from 4.8% in 1Q2020 (see Social Spending). Authorities even spent 8% less on education and 5% less on healthcare, compared with 2Q2019. As a result, overall social welfare expenditure declined by 3%, just as households needed it most. This was a hard reality of the lockdown to control the virus: a closed system had fewer opportunities to put money to work.

**Primary Indicator: Wage Growth Relative to GDP**

Ratio

**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


**Supplemental 4: Government Social Expenditures**

4qma, percent


**Policy Analysis**

Beijing is proposing digital solutions to support employment and consumption. On July 14, the State Council issued an opinion promoting online education, remote work, digital trade, e-commerce, social media, and live streaming. It encouraged self-employed, part-time work and entrepreneurship to support these internet-based activities. On July 31, the Council published another
opinion supporting flexible employment and encouraging workers to find sources of income beyond their formal jobs. These policies aim to create new opportunities for China’s workforce, but doing so is easier said than done.

Final Dashboard Assessment

Among the ten reform areas tracked in the China Dashboard, labor reform has regressed the most. The 2013 Third Plenum covered a wide range of labor issues with a focus on letting workers share in China’s economic growth, but the gap between wage and GDP growth is larger than ever. The government promised to end job discrimination and improve social welfare. And yet, migrant workers still experience slower wage growth, and government spending on social welfare as a percentage of GDP has declined from 2015 levels. Beijing has come up short of the ambitions set out at the start of the Xi years.

This was not for a lack of effort. The past five years saw important changes. For example, the government removed household registration (hukou) restrictions in cities with fewer than 3 million residents and lowered requirements for cities with 3-5 million residents (see Summer 2019 Edition). Beijing is making progress on pension fund centralization (see Fall 2018 Edition), expanding health insurance coverage and extracting social security funds dividends from state-owned enterprises (see Fall 2019 Edition). Beijing assumed some welfare spending obligations from local governments and restructured the bureaucracy to spend money more efficiently (see Summer 2018 Edition). But all these efforts have failed to increase worker compensation, job security and protections, and shared welfare.

Fiscal imbalances remain the biggest constraint on implementing bolder labor reforms. Local governments still bear most of the responsibility for social welfare but lack the wherewithal. Tax revenue comes not so much from incomes or consumption but from local businesses and land sales. Therefore, authorities are less focused on services for lower-income groups and more on support for businesses.

The 14th Five Year Plan, previewed in October and to be released in early 2021, will lay the groundwork for future labor policies. These will include easing more household registration restrictions in larger cities, widening health insurance coverage, and better coordinating social services across cities. But unless Beijing makes progress on fiscal reform and resolves the central-local fiscal imbalance problem, labor reform is unlikely to deliver meaningful outcomes. A failure to bolster household incomes and worker welfare at a time when the traditional drivers of China’s economy—credit expansion and property construction—are fading will lead to weaker consumption and declining productivity. That would undermine recovery and erode long-term prospects.
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

- Our assessment remains negative this quarter, as we observed no progress in land reform in 2Q2020. Local governments introduced measures to increase compensation for rural land sales, but only in three provinces.

- Only 0.1% of total rural nonagricultural land has been transferred at market prices.

- Beijing asked local governments to use more of the proceeds from land sales to help rural residents, but the impact of this change will be minimal. Looking forward, serious reform is unlikely, as local
governments have become more reliant on land sales than they were five years ago.

This Quarter’s Numbers

For the fourth consecutive quarter, the central government produced no new data for agricultural or nonagricultural land reform in 2Q2020. The portion of rural nonagricultural land that has been transferred at market prices remained at just 0.1% of the total area. Authorities launched new pilots in December 2019, but meaningful results will take more than a year to be reflected in the data.

More local governments are increasing the amount paid to farmers who sell their land to the state. In addition to Jiangsu province, discussed in the Summer 2020 Edition, Zhejiang and Shandong provinces also revised up their compensation standards in 2Q2020. Zhejiang raised compensation by 15%–50% from 2014 levels (the last time it revised the standards) with bigger increases in less developed areas. Shandong raised compensation by around 20% from 2016 levels for most rural land. But these increases were smaller compared with those in urban areas, which rose by 20% in Tier-2 and Tier-3 cities, and by 40% in Tier-1 cities between 2015 and 2020 (see Urban Land Prices). The enormous gap between urban and rural land prices incentivizes local governments to expropriate cheap land from rural residents and sell it to developers at high prices. Closing this gap is fundamental to advancing land reform.

Reducing government control over rural land transfers remains a distant goal, as local governments continue to rely on land sales to patch fiscal shortfalls. Land sales rose by 5% year-on-year (yoy) in 2Q2020, rebounding from -8% toy 1Q2020 (see Land Requisition Financials). At the same time, Beijing has kept restrictions on property market activity to prevent the property bubble from growing, resulting in slower land price growth across all city tiers. In the long term, weaker prices should reduce local governments’ reliance on land sales.

Although there has been little reform progress in relation to rural nonagricultural land, rural residents continue to benefit from past reforms of agricultural land, under which they can lease out their land for rental income. Agriculture-related loans rose by 6.2% yoy, and rural property income climbed 13.8%, the fastest growth for both since 2Q2018 (see Rural Credit). However, these improvements mainly reflect easier credit conditions in response to the pandemic and may fade without reform progress.
Supplemental 3: Urban Land Prices

RMB per square meter

Source: Ministry of Natural Resources.

Supplemental 4: Rural Credit

Year-over-year


Policy Analysis

In the summer 2020 review period, Beijing continued to emphasize the role of local governments in mediating land sales—contrary to the reform goal of marketizing rural land sales. At the same time, it asked localities to use more of the proceeds from land sales to help rural residents. On September 23, the Party and State Council jointly introduced a policy requiring local governments to gradually raise spending on “rural affairs” to 50% of land sales profits by 2025. However, the definition of “rural affairs” is ambiguous: it can range from infrastructure and agricultural activities to community services and social welfare. Local governments, therefore, do not necessarily need to spend the money on rural households.

Beijing knows that local governments may manipulate the booking of land sale profits to inflate rural affairs spending. Hence, the policy further specified that local governments need to spend at least 8% of their land sales revenue—the total sales value, usually five times greater than just the profit—on rural affairs. But according to the Ministry of Agricultural and Rural Affairs, local governments had already spent 6.6% of the RMB 28 trillion (about $4 trillion) of land sales revenue (or 33% of land sales profit) on rural affairs in 2013-2018. As China now sells RMB 6-7 trillion ($1 trillion) worth of land a year, local governments will only need to spend RMB 20 billion ($3 billion, or 0.3% of revenue) more a year on rural affairs, just 1% higher than the current level.

Final Dashboard Assessment

Looking back, land reform has barely progressed over the past five years. While the 2013 Third Plenum promised to allow rural residents to transfer their land via the land market, authorities have only piloted this reform in 33 counties, accounting for just 0.1% of China’s total rural nonagricultural land. These pilots concluded with a modest revision of the Land Management Law in 2019, which removed the main legal obstacles for transferring rural land in the urban market but reinforced the strong governmental role in planning and allocating land (see Fall 2019 Edition). Beijing even delegated more power to provincial governments to speed up the urban land use approval process, which may give them more room to profit from land sales at the expense of rural residents (see Spring 2020 Edition).

Looking ahead, land reform is likely to proceed at a very slow pace, taking years to deliver meaningful changes. New pilots to enable rural landowners to sell land in the urban market were announced in December 2019 (see Winter 2020 Edition), and authorities are considering new policies to allow more flexible use of rural land designated for residential purposes (see Summer 2020 Edition). These initiatives suggest that Beijing is still exploring ways to use rural land more productively, a goal likely to be repeated and framed as “reform” in the 14th Five Year Plan next year. However, there are no signs that Beijing is prepared to fully empower rural households yet, and any attempt to do so would face strong resistance from local governments that have become more reliant on land sales than they were five years ago.
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 downgrade our assessment of SOE reform in this quarter, as state investment continued to outpace private investment, and policies encouraged a more expansive state sector.

- SOEs continued to underperform private firms but invested more based on top-down instructions from the state. In the first eight months of 2020, SOE investment grew by 3.2% year-on-year (yoy) while private investment fell by 3.8%.

- Beijing is doubling down on existing policies to increase SOE competitiveness and innovation capacity while trying to extend its influence into the private sector.
This Quarter’s Numbers

SOE reform did not progress in 2Q2020. Among listed firms, the SOE revenue share in “normal” commercial industries—where Beijing promised to withdraw state influence—remained about the same as 1Q2020. It increased in “pillar” industries, which Beijing considers strategic to China’s economic development, to 43.5% from 43% in the first quarter. In other words, SOEs maintained their presence in commercial sectors where Beijing had committed to letting the market play a bigger role.

Interestingly, SOE revenue share in “key” industries including defense, utilities, and aviation, where Beijing hoped to bolster state control, declined sharply this quarter, falling to 81.6% from 84% in 1Q2020. The lower SOE presence in key industries resulted from the revenue collapse in the airline industry, which is dominated by SOEs, due to COVID-related lockdown measures rather than privatizations. SOEs’ revenue weight in these key industries is likely to rebound in 3Q2020 as China’s domestic air traffic recovers.

SOEs continued to underperform private firms even as Beijing vowed to improve their efficiency and private firms were more vulnerable during the pandemic. In the industrial sector, SOE revenue barely grew in 2Q2020, while private firm revenue was 6% higher than in 2019, as they benefited more from China’s export recovery. Nonetheless, Beijing pushed SOEs to expand investment to stabilize the economy. State investment increased by 3.2% yoy in the first eight months of 2020, compared with a 3.8% yoy drop in private investment.

Primary Indicator: Share of SOE Revenues in Different Industry Categories

Source: Bloomberg, Rhodium Group.
SASAC’s assessment of SOE reform over the past five years is at odds with our findings. It declared “mixed ownership” reform—a mechanism expected to lead to some partial SOE privatization—a success. Mixed ownership reform has attracted more than RMB 1.5 trillion ($220 billion) in private capital to central SOEs. However, our primary indicator shows no meaningful shift toward private control among listed firms. (Our primary indicator sets a 20% state ownership threshold for SOEs. While there have been several instances of changing classifications from SOE to private firms and vice versa, in aggregate they are not significant enough to shift our indicator.) Today, SASAC encourages more mergers and acquisitions between SOEs and private firms, arguing that this can improve competitiveness. It certainly will not improve competition inside China.

Final Dashboard Assessment

SOE reform has been redefined from the 2013 vision. Seven years ago, Chinese leaders made three pledges on state firms: (1) SOEs would be concentrated in key and pillar industries, leaving normal commercial industries to the market; (2) SOEs would be restructured to operate more efficiently; and (3) SOEs would help increase social safety net spending.

Beijing remains far from realizing these goals. It “corporatized” SOEs in 2017 (see Fall 2017 Edition), diluted the state’s shareholding in giant telecom SOE Unicom (see Winter 2018 Edition) and many smaller SOEs (see Summer 2020 Edition), ordered SOEs to reduce their financial leverage (see Spring 2018 Edition), linked SOE employee salaries to productivity (see Summer 2018 Edition), and forced SOEs to transfer 10% of state equity to social security funds (see Fall 2019 Edition). However, the presence of SOEs across industries has barely changed, their efficiency has not improved, and more than 70% of dividends paid were reinvested back into SOEs themselves, not used for social spending (see Spring 2019 Edition). These reforms have failed because SOEs lack incentives to exit commercial industries (leaving them to more competitive private firms) to politically dominated key and pillar industries where security and strategic considerations justify state presence. Stronger Party supervision has made it harder for SOEs to act on commercial incentives. These contradictions have intensified in recent years, meaning that serious reform is less likely going forward.

The Party is also enhancing its influence over the private sector. On September 15, the Party and the State Council issued an opinion on strengthening “United Front Work” in the private sector (informal, nonregulatory/institutional

Policy Analysis

This quarter saw more of the same on SOE reform. Policies aimed to improve SOE efficiency while increasing market influence, yet with firm Party control. The Party is now trying to extend its influence to private firms, further blurring the line between the state and the private sector in China. We are highly skeptical that this mix of efficiency and Party control is a viable aspiration.

On October 12, the State-Owned Asset Supervision and Advisory Commission (SASAC) held a press conference on the three-year outlook for SOE reform. It named eight priorities, including continuing mixed-ownership reform, focusing on state management of capital instead of assets, and strengthening the role of the Party. These are all existing policies being implemented. A new development is that technological innovation has moved to the forefront of SOE reform. SASAC is urging key SOEs to increase their R&D expenses as a share of revenue to 5% by 2022, compared with only around 2% today.

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interactions to augment Party influence). While Party interference in the private sector is not new, this campaign reflects a major reimposition of ideology on private business. The policy calls for ensuring a team of private businesspeople that is “dependable and usable in key moments.” It asks private firms to align themselves politically with the Party and envisions recruiting more Party members from the private sector. At the same time, it promises to improve market access for private firms in strategic sectors and allow private entrepreneurs to participate in policymaking, which sounds to many like a threat to deny those privileges to firms that do not consent to Party influence. The dividing line between the state and private sector is more blurred than in years and is likely to get even more so.
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. On November 15, 2020, China signed the Regional Comprehensive Economic Partnership (RCEP) with 14 other countries including Japan, South Korea, Australia, New Zealand, and the 10 Association of Southeast Asia Nations (ASEAN) member states.

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 (CTL) with an alternate indicator due to missing data.

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

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

Quarterly Assessment and Outlook

- Our trade reform assessment remains neutral: services trade openness improved (albeit to 2014 levels), while consumer goods trade openness declined.

- COVID-19–related exports of PPE and electronics products pushed the 2Q2020 goods trade surplus to its highest in history, inflaming foreign concerns.

- To hedge against risks from tensions abroad, Beijing is pursuing both trade deepening with pliant regional partners and reduced reliance on foreign suppliers in technology and strategic sectors.

This Quarter’s Numbers

Services trade saw opening in 2Q2020, while goods trade openness further declined. Our Composite Trade Liberalization Index (CTLI) showed the services proxy finally getting back to 2014 levels in terms of openness. Telecommunications, royalty payments, insurance and pension services all increased year-on-year (yoy) in 2Q2020 and 3Q2020 (see Services Trade Openness). However, consumer goods imports relative to GDP have continued to fall since 2018. The decline accelerated during COVID-19, as domestic demand slackened, reducing imports. This corresponded to China’s new initiative to refocus its exporters on domestic market opportunities.

China’s export sector rebounded in 2Q2020 as manufacturers resumed activity post-virus lockdown and demand for COVID-19–related goods in other economies surged. Authorities intervened to limit renminbi appreciation in 2Q2020, which helped to boost exports (see Exchange Rate Fluctuation). Strong exports, falling import prices, and weaker domestic demand pushed China’s 2Q2020 goods trade surplus to $161.3 billion (4.6% of GDP)—the highest ever recorded—and drove the current account surplus to 3.1% of GDP, its highest since 2012 (see External Trade). Despite the export surge, net exports of steel and aluminum continued to decline, raising hopes that overcapacity in these products may be receding (see Trade in Overcapacity Goods).

Ballooning imbalances will aggravate concerns about China’s trade footprint; if trends persist, the 2020 current account surplus will surpass 2016 levels. Robust exports and weak imports have slowed China’s intended shift away from the “import-for-export” model (see Structural Change in Goods Trade). With the new “dual circulation” strategy, Beijing has signaled the intent to boost consumption while reducing global reliance by substituting strategic imports with domestic production.
Policy Analysis

To hedge against risks from economic tensions abroad, Beijing is pursuing both trade deepening with pliant regional partners and targeted reduction of reliance on foreign suppliers in technology and strategic sectors. The new dual circulation strategy, which will be central to China’s 14th Five Year Plan (FYP) for 2021-2025, calls for less reliance on foreign technology and trade and a greater focus on domestic consumption. It encompasses both “external circulation” (accessing global demand and foreign capital and technology) and “internal circulation” (stocking domestic demand and domestically developed technology). President Xi Jinping’s explanation of the program emphasizes shifting growth momentum to domestic demand, domesticized supply chains, and indigenous innovation. While the net impact on China’s trade balance is unclear, the import-substitution elements in the strategy do not auger well for reform. Import substitution in key technologies and critical supply chains will likely lead to measures protecting domestic manufacturer market shares and restricting foreign players.

Beijing continues to encourage trade opening in less technology-intensive sectors. At the November Shanghai Import Expo, President Xi announced a new “Negative List” on cross-border services trade to improve market access. He also said China would accelerate free trade agreement negotiations. On November 15, China signed the Regional Comprehensive Economic Partnership (RCEP) with 14 other countries including Japan, South Korea, Australia, New Zealand, and the 10 Association of Southeast Asia Nations (ASEAN) member states.

The deal is strategic for China, as it can strengthen regional economic ties to offset the prospect of U.S. decoupling. RCEP is far from comprehensive: it mostly codifies tariff reductions that already exist in other
agreements, with the important exception of China-Japan trade. Nevertheless, the agreement is an important signal of China’s intent to expand and deepen regional economic integration, and it has prompted some soul searching in Washington and European capitals.

While RCEP is encouraging on paper, it is not stopping Beijing from using trade to bash Australia for unrelated, alleged affronts. China is impeding market access for Australian goods in retaliation for Canberra’s “poisoning” bilateral relations with calls for an inquiry into the COVID-19 outbreak, charges about human rights and cybersecurity violations, reluctance to permit Huawei to sell 5G telecoms gear, and other non-trade issues. China has recently imposed tariffs exceeding 200% on Australian wine and restricted Australian coal, lumber, seafood, beef, and barley imports. There is no subtlety to these draconian measures, and they are leading U.S. allies and partners to voice concerns.

**Final Dashboard Assessment**

In trade, China remains a contradiction. It is the world’s biggest trader in absolute terms; however, relative to its economic size, trade liberalization has not kept pace. Trade reform commitments set out in Beijing’s 2013 Third Plenum program included two major tasks: promote trade openness and let the market play a decisive role in adjustment. China continuously reduced tariffs since our first Dashboard observation with cuts bringing simple average tariffs to 7.6% in 2019 from 9.9% in 2013, according to the World Trade Organization (WTO). However, Beijing raised tariffs on nearly all imports from the United States amid the tensions of the past two years, causing China’s average tariff rate to rise to 9.8% in 2018. China has not made equivalent progress in reducing non-tariff barriers to trade and continues to use an unlimited array of administrative interventions as coercive, informal tools of statecraft. Despite China’s claims to the mantle of trade liberalization leadership, our indicators show openness in non-strategic, highly protected goods categories has only decreased since 2013.

China’s external trade imbalances, once expected to moderate, have surged back to dangerous levels over the past year. Unending financial enablement of already excessive production spilled directly and indirectly into China’s exports in the early Xi years, fueling massive goods surpluses in 2015. The overcapacity problem caused global oversupply of industrial materials like steel and aluminum as well as in other subsidized output like solar panels, batteries, and fertilizer. Overcapacity exports have receded from peak levels after repeat campaigns consolidated industry players and tried to match supply with actual demand, though sheltering domestic manufacturers from real conditions and financial costs will cause the overcapacity problem to persist. After deleveraging the financial system and liberalizing some trade flows, that problem started to recede.

As recently as 2019, China was expected to move toward a structurally lower trade surplus, or even a trade deficit, as stronger domestic demand and services sector growth boosted imports. But the COVID-19 debacle seems to have altered that trajectory. The dual circulation strategy pledges to unleash domestic sources of demand but to curtail foreign suppliers from realizing their comparative advantages to satisfy it. Going forward, China’s trade reform outlook looks like a closed-circuit liberalization that hoards the domestic dividends of competition, should they finally arrive, for home-team firms and selected foreign friends willing to play by authoritarian-friendly rules.