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Marketisation under the Party's Command: An Interim Balance of the Economic Reforms since the Third Plenum

Fewer controls in the financial system, stronger state-owned enterprises and a more transparent fiscal system

by Sandra Heep, assisted by Mirjam Meissner

Central findings and conclusions

- The comprehensive reform package is geared towards paving the way for a new economic model based primarily on three growth drivers: domestic consumption, service provision and innovation.

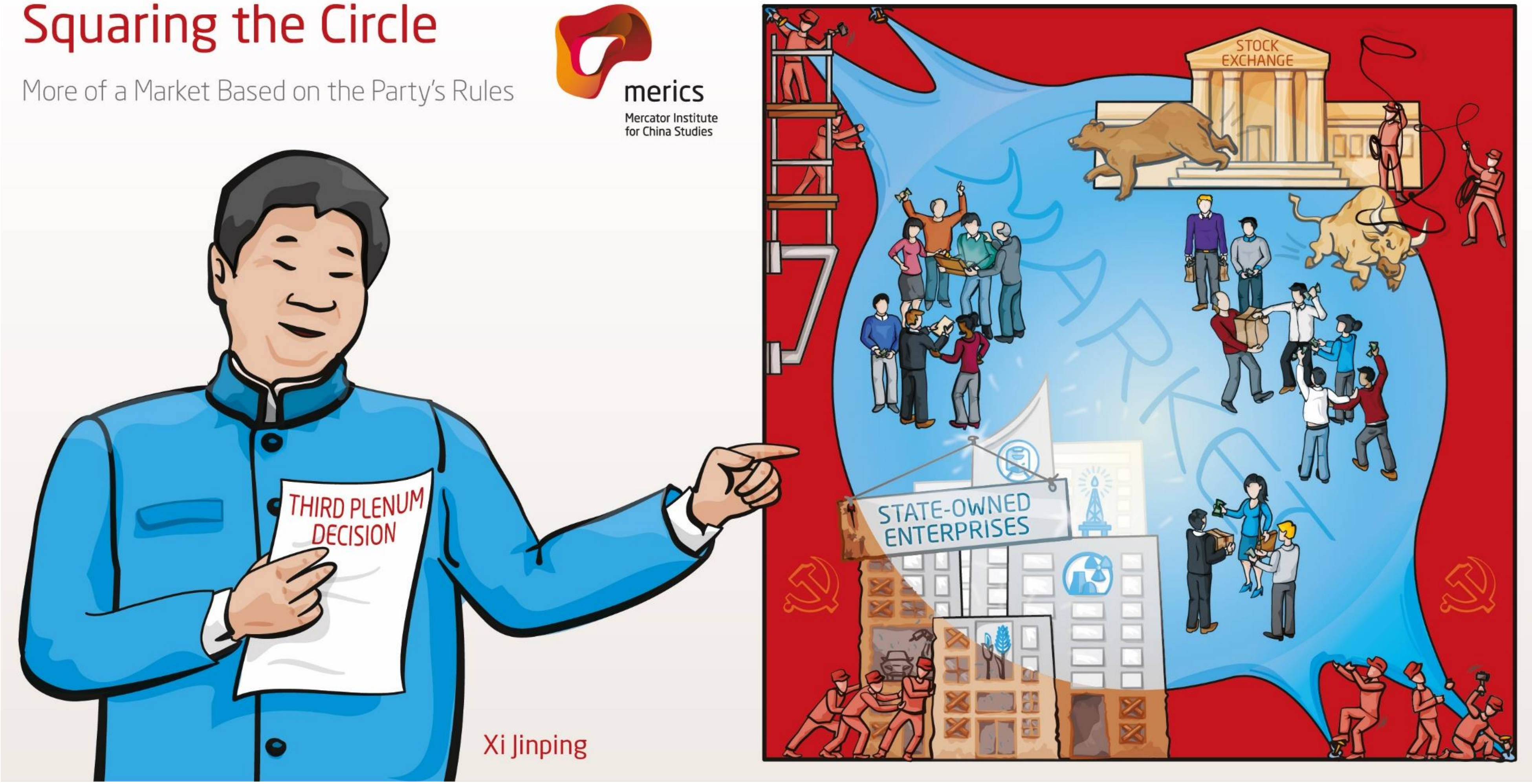
- The CCP has announced that it will apportion the market a "decisive role" in the allocation of resources. However, it wants the efficiency of the market to unfold within the framework of an economic system which remains closely steered by the state. The reform process has been plagued with inconsistencies, setbacks and delays as a result of this ambivalence.

- In addition, dropping growth rates threaten to become an obstacle to the reform agenda: the more pronounced the economic downturn, the greater the risk that the government will be seduced into implementing new stimulus packages. This would alleviate the economic problems in the short term and appease dissatisfaction in the population, but it would also make the reforms increasingly difficult to implement and China would run the risk of entering a long period of stagnation.

- When measured against the objectives defined by the CCP, progress of reforms in the **financial system** has been mixed: while the banking system has seen considerable change, mainly as a result of greater flexibility in the interest-rate regime, state interference in the stock markets has caused huge setbacks in the development of the nation's capital markets.

- The results are similar for the **fiscal system**: while the government introduced reforms to increase transparency in budget planning and debt management, the gaping holes in the coffers of local governments still remain, as the necessary redistribution of resources has met with considerable political resistance.

- The overall balance for **state-owned enterprises** is a negative one: not only have the reforms in this area been extremely slow, but the current trend towards mergers also conflicts starkly with the strengthening of competition heralded by the CCP. Measures such as the establishment of holding companies are also problematic from an economic viewpoint as they do not seem to be conducive to a more efficient allocation of resources that would give the economy a new boost. .


Squaring the Circle
More of a Market Based on the Party's Rules
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THIRD PLENUM DECISION
Xi Jinping
STOCK EXCHANGE
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STATE-OWNED ENTERPRISES

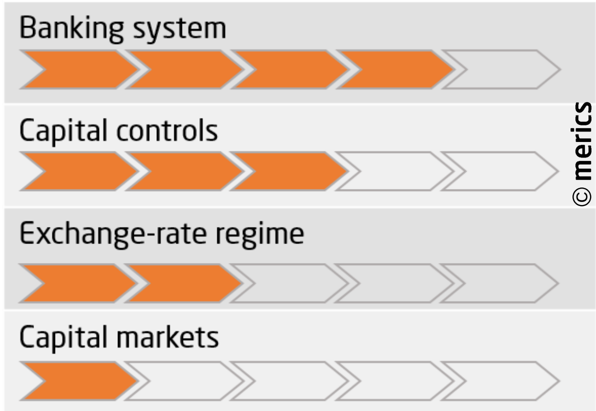
1. Introduction

Two years ago, the Central Committee of the CCP passed one of the most ambitious reform programmes the People's Republic has ever seen.[1] The seemingly endless list of structural reforms was motivated by the realisation that the old growth model based heavily on investment and exports had finally reached its limits. This complete overhaul of the economic ground rules was intended to pave the way for a new model based primarily on three growth drivers: domestic consumption, service provision and innovation. Many foreign commentators initially jumped with joy at the prospect of the market being given "a decisive role in the allocation of resources", yet many appear to have overlooked the fact that the state sector's dominant position was to be maintained. However, the last few years have shown unmistakably that the CCP is intent on squaring the circle and is determined to achieve more market efficiency within the framework of an economic system that continues to be steered by the state. This issue of *China Monitor* will examine what progress has been made in three areas that are of particular systemic importance: the financial system, state-owned enterprises and the fiscal system.

2. The financial system: taking two steps forward, then one step back

State control of the financial system remains a firm favourite in the CCP's economic policy toolkit, with financial resources tending to be distributed according to political criteria rather than economic interests. While state-owned enterprises that are not very profitable enjoy almost unlimited support from state-owned banks, many innovative private companies have little choice but to seek funding from the shadow banking sector – at extortionate interest rates. What's more, administratively controlled interest rates and strict capital controls have not only hindered the emergence of competition in the banking system, but have also limited consumer spending power by keeping interest rates artificially low. A new growth model with a stronger focus on domestic consumption and innovation cannot be reconciled with such a financial system, however. For this reason, the Central Committee announced that the financial system would be fundamentally restructured, entailing both a reform of the banking system and capital markets and a more flexible approach to the exchange rate and capital controls.

Progress in implementing the CCP's reform resolution: financial system



Progress on a scale from 1 – 5[2]

2.1 The banking system

The last two years have seen a great deal of change in China's banking system, the most important step being the more flexible handling of interest rates. The ceiling on deposit rates was initially relaxed in a number of steps and was then completely abolished in October 2015. As a result, China officially no longer has any administrative controls on interest rates. This greater flexibility was supplemented by the launching of a deposit insurance scheme in May 2015. This scheme is intended to put smaller banks in a stronger position when it comes to competing for deposits. This is supposed to improve innovative private firms' access to finance, as smaller banks are more willing to provide credit to private businesses than the large state-owned ones are.

The authorisation to open up the first private banks was aimed at strengthening competition in the banking sector as well. In 2014, five different companies were awarded such licences, including the internet giants Alibaba and Tencent, which are able to profit from the wealth of customer data they already have at their disposal when it comes to providing online financial services. In the medium term, these online banks may be able to help close a gap in China's financial system by supplying small businesses with loans.

These reforms should not, however, be considered a retreat from the financial system by the state; the government very much intends to keep the major players in the banking system squarely under the state's control. This means that, despite the official flexibilisation of the interest-rate regime, it still has the possibility of influencing rates "through the back door".

2.2 Capital controls

The government has also pressed ahead with relaxing capital controls. One of the main objectives of the greater opening of the capital account was to create the necessary conditions for the renminbi to be included in the International Monetary Fund's (IMF) basket of Special Drawing Rights (SDRs) – a matter of high priority for the government, not least for symbolic reasons. Of particular importance here are the connection between the stock exchanges in Shanghai and Hong Kong that was established in November 2014, better access to the interbank bond market, which was granted to specific foreign investors, and less stringent regulations on cross-border cash-pooling for companies. Furthermore, in October 2015, the State Council presented the prospect of a pilot project for trialling a new investment channel in the Shanghai Free-Trade Zone, which is intended to allow Chinese investors to make individual portfolio investments abroad.[3]

This controlled opening via clearly defined investment channels shows that the government has no intention of completely liberalising the capital account. It is rather trying to design a system that allows for a freer movement of capital but at the same time prevents speculative capital flows that would pose a threat to the country's economic stability.

2.3 The exchange-rate regime

The increased flexibility in the exchange-rate regime is also linked to the government's efforts to prepare the renminbi for the IMF's SDR basket. The most significant change in this regard was made by the People's Bank of China (PBOC) in August 2015. To be able to understand this reform, it is important to know how the Chinese exchange-rate regime works: the PBOC determines a daily reference rate from which the exchange rate can vary up to two per cent in each direction. Before August 2015, these fluctuations did not necessarily affect the reference rate set the following day, but they have had a decisive influence on the daily rates ever since then.

Since investors around the world were alarmed by this change, considering it to be a devaluation drive, there was a real risk of the renminbi suffering severe depreciation. To counteract this, the PBOC has continually been making supportive purchases on the currency markets ever since. **As a result, the newly found flexibility has been neutralised by state interference. The reform has thus not been properly implemented yet.**

2.4 Capital markets

The government's reforms to the bond markets have so far only achieved modest results. The China Securities Regulatory Commission extended the market for corporate bonds in January 2015 by allowing companies without a listing on the stock exchanges to issue bonds. In addition, in July 2015, the PBOC made it easier for foreign central banks, sovereign wealth funds and international finance organisations to access the interbank bond market. The introduction of local-government bonds was also meant to give the bond markets fresh impetus, but this measure has only been moderately successful: the market has grown considerably due to this new bond category, but by mandating state-owned banks to buy these bonds, the government both subverted the banks' commercialisation and brought about an even greater bias in the interest-rate structure on the bond markets.

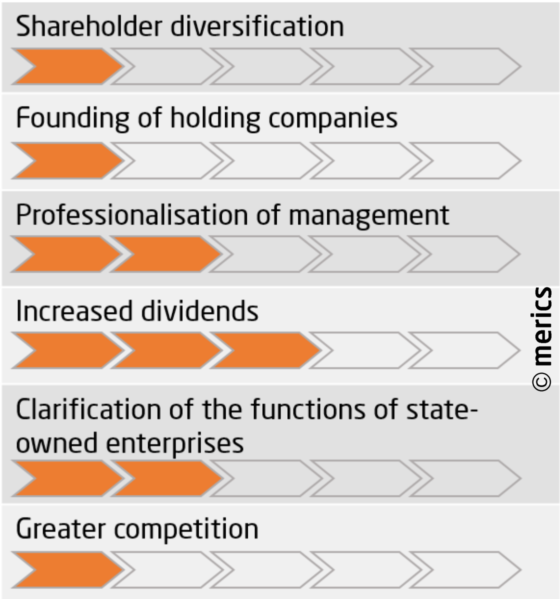
The latest developments on the equities market seem to be downright disastrous: since the summer of 2014, the government has been using propaganda channels to try to entice households into investing on the stock market. Its intention was to make it easier for heavily indebted state-owned enterprises and technology start-ups lacking capital to get funding this way. In the beginning, it looked as though the bid was going to be successful. The rude awakening came when the bubble burst in the summer of 2015, however. In an attempt to stave off the slump in prices, the government pulled out all the stops it could think of. Among other things, it allowed more than half of China's listed companies to suspend trading in their shares, forced state investors into support buying on a huge scale, and banned large investors with shares in companies of over five per cent from selling their shares for a period of six months. Legal certainty on China's equities markets has never been at such a low point. For those who are still daring enough to invest on these markets, the only indicators they can use to guide them are the political signals coming from the government. **The aim of turning the equities markets into a sturdy pillar of corporate financing consequently has receded into the distance. In addition to that, the government's bid to internationalise the financial system has suffered a major setback:** in the eyes of foreign investors, China's capital markets have lost much of their sparkle as a result of government intervention.

3. SOE reform: proceeding at a snail's pace, and possibly in the wrong direction

China's state-owned enterprises are hampering the efficient distribution of resources. Many of them are not only highly indebted, but are also considerably less profitable than private companies. Even so, they can generally still obtain funding from the state-owned banks at favourable conditions, whereas many innovative private companies are forced to rely on the shadow banking system. China's leadership is certainly aware of this problem, but it does not intend to let the state sector undergo a drastic shrinkage by any means. Rather than allowing that to happen, it wants to increase the efficiency of state-owned enterprises through a series of small changes in an effort to strengthen them. The resolution passed by the Third Plenum in November 2013 consequently included numerous reforms, at the centre of which are shareholder diversification and the founding of holding companies.

Numerous foreign commentators understood the reform decision as heralding a wave of privatisation, although there was never actually any mention of this being a desired objective. Although the steps that have been taken so far have been disappointing from a foreign point of view, they have, in fact, followed the decision of the Third Plenum to the letter. Conflicts of interest between different ministries have led to considerable delays, however.

Progress in implementing the CCP's reform resolution: state-owned enterprises



Concrete progress has only been made in two areas. The Ministry of Finance decreed a dividend increase of five per cent in 2014, meaning that dividends rose up to 25 per cent, depending on the sector concerned (this top figure applies to the tobacco industry). In addition, managers of companies started to receive performance-related pay in 2015, something which has resulted in considerable pay cuts for numerous executives working in state-owned enterprises.

The *Guideline to Deepen SOE Reforms* was not published by the Chinese State Council and the CCP Central Committee until September this year.[4] Although the framework document was quite some time coming, the key points in it are vague and it only gives a sparse indication of how exactly the reforms are to be implemented. To name but one issue, it is still not clear how the holding companies will be organised as the Ministry of Finance and the State-owned Assets Supervision and Administration Commission of the State Council have opposing views on the matter. One thing the document does make clear is that the amount of influence that party groups have within state-owned enterprises is to be increased. This naturally raises the question of how this can be reconciled with the objective of increasing SOEs' profitability.

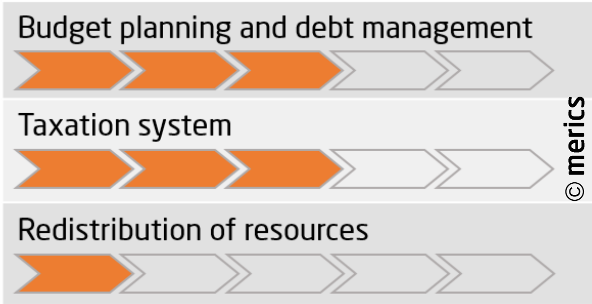
The pilot projects implemented to date have not proven that shareholder diversification or the establishment of holding companies are suitable ways of increasing efficiency in the state sector either. The experiments carried out by the financial conglomerate CITIC and the oil company Sinopec suggest that the sale of company shares does not necessarily translate into a significant expansion of influence from private investors. At the same time, the merger of train manufacturers CNR and CSR that was accompanied by the creation of a holding company has shown that the aim of this restructuring of the state sector is clearly to increase the market dominance of state-owned enterprises even further. Those still hoping for a breaking up of monopolies will be sorely disappointed.[5]

Reforms to the state-owned enterprises over the last two years have proceeded at a snail's pace and in a direction that is far from promising; it seems unlikely that strengthening the role that the Party plays in SOEs, selling minority stakes to private investors and facilitating a wave of mega-mergers will result in greater profitability. Nevertheless, private and foreign investors must both brace themselves for growing competition from China's state-owned giants, both within China itself and on international markets. Although very few of these companies are actually competitive in their own right, they will be given all the backing they need as long as the state has the necessary funds.

4. The fiscal system: the biggest hill is yet to be climbed

China's fiscal system is essentially a huge patchwork rug threatened with being torn apart as a result of conflicts over the distribution of resources between different levels of government. Local governments have been struggling with chronic shortfalls in their coffers ever since the 1990s and have been forced to rely on opaque funding channels. Their financial situation turned truly dire when the central government mandated them to absorb the blow of the global financial crisis with gigantic investments in infrastructure. As they had to pay these investments out of their own pocket, many local governments have consequently seen their levels of debt spiral out of control – something which has gradually become one of the greatest risks to China's financial stability. In view of this, the Central Committee announced a fundamental reorganisation of the fiscal system, including reforms to budget planning and the taxation system as well as redistribution of responsibilities and resources among the different levels of government.

Progress in implementing the CCP's reform resolution: fiscal system



4.1 Budget planning and debt management

The last two years have seen China's government vehemently pressing ahead with restructuring the fiscal system. It has been particularly active in the areas of budget planning and debt management. The National People's Congress passed a revised budget law as far back as August 2014 which repealed the official ban on accumulating debt for local governments and allowed governments at the provincial level to issue bonds. At the same time, it also obliged the central and local governments to disclose information on all of their income and expenditure and to draft multi-year budgets to allow for a more long-sighted fiscal policy.[6]

In the following month, the State Council defined general guidelines for dealing with local government debt. These prohibited local governments from taking out further loans via obscure financing platforms which had helped them circumvent the official ban on debt up to that point. In addition, local governments were also instructed to comply with the debt limits specified by the central government and to disclose all debts in their budgets.[7] **The implementation of these new regulations will doubtless see considerable delays, but the reforms are pointing clearly in the right direction.**

The debt-rescheduling programme launched by the Ministry of Finance in March 2015 can only be rated as a partial success, however. The aim of this scheme was to decrease the debt burden suffered by local governments by allowing them to convert loans taken out by their financing platforms into bonds with longer maturities and at lower interest rates.[8] The first attempt to implement the scheme experienced difficulties as investors were not prepared to buy the high-risk bonds at such low interest rates. Working in conjunction with the Central Bank and the China Banking Regulatory Commission, the Ministry of Finance summarily instructed the banks to substitute the loans they had given to local financing platforms for the newly issued bonds.[9] This succeeded in improving the precarious financial situation of the sub-national governments. However, the central government's intervention was a setback for reforms in the financial system, since it both undermined the banks' commercialisation and brought about an even greater bias in the interest-rate structure on the bond markets.[10]

4.2 Taxation system

The current outcome in the taxation system is also somewhat mixed. **The government has made particularly good progress in tax reforms aimed at promoting more environmentally friendly economic growth.** Of special note is the State Council's draft law on environment tax, which it released in June 2015.[11] The conversion of business tax into VAT which started in 2012 has also advanced further over the last few years. The reform is aimed at strengthening the service sector, but it is having a problematic side effect: it is diminishing regional and local governments' inadequate tax revenues even further since unlike business tax, the lion's share of VAT income flows directly into the central government's coffers. The introduction of a property tax meant to stabilise the financial situation of local governments is still in the pipeline. However, the technical requirements for future taxation have already been established thanks to the introduction of a property registration system launched in March 2015.

4.3 Redistribution of resources

No progress whatsoever has been made in the redistribution of resources between the various levels of government. This is not at all surprising, bearing in mind that redistribution in any political system will always come up against considerable resistance. However, this reform bottleneck is having a potentially devastating effect on the financial situation of local governments – and therefore on China's economic stability as a whole. On top of that, the lack of progress might undermine the reforms in budget planning and debt management: as long as the holes in the coffers cannot be plugged, local CCP functionaries will have no other choice than to try and circumvent the rules and seek financing from opaque sources. **In short, China's fiscal system cannot be given the all-clear while redistribution remains an insurmountable challenge.**

5. Summary

Two years after the Third Plenum, the outcome of the reforms in the financial and the fiscal system is a mixed one when compared to the objectives defined by the Party. Whereas the **banking system** has seen considerable progress, mainly as a result of increased flexibility in the interest-rate regime, state interference in the **stock markets** has meant huge setbacks in the development of capital markets. As for the **fiscal system**, although the government has introduced reforms to increase transparency in budget planning and debt management, the gaping holes in the coffers of local governments still remain as the necessary redistribution of resources has come up against considerable political resistance.

In contrast, the balance for **state-owned enterprises** is clearly a negative one: not only have the reforms in this area been extremely slow to date, but the current trend towards mergers also conflicts starkly with the strengthening of competition heralded by the CCP. Measures such as the establishment of holding companies are also problematic as they do not seem likely to lead to a more efficient redistribution of resources, which would give new impetus to the economy.

The future progress of reforms will depend to a great extent on how the economy grows: the more pronounced the economic downturn, the greater the risk that the government will be seduced into implementing new stimulus packages. This would alleviate the economic problems in the short term and appease any dissatisfaction in the population, but it would also make the reforms increasingly difficult to implement and China would run the risk of entering a long period of stagnation. However, even if this scenario should not arise, any attempts by the CCP to achieve greater market efficiency while still maintaining a decisive grasp on the economy will lead to further inconsistencies, setbacks and delays as the reforms are implemented. **As a result, China is set to remain an unsteady business partner for years to come.**

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