ASIA PERSPECTIVE

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This Issue

Continued growth, but time for change

On the 9th of November, China's most powerful and influential political figures met in Beijing to discuss the political agenda for the Communist Party. The meeting is called the Central Committee Meeting and this time it was the third session of the 18th Central Committee that convened. This meeting, formally called the Third Plenum of the 18th Central Committee, has been one of the most important events in Chinese politics in recent time since it is the first Central Committee meeting since president Xi Jinping took office.

The meeting comes as China faces major economic and social challenges. With its growing economy, to a large extent fueled by bad credit, China is facing several structural problems and the main challenge for China's leadership is to reform the financial system in a manner which avoids a financial crisis. Xi Jinping indicated prior to the meeting to foreign leaders that this meeting would be the most important, with regards to reform, since the Third Plenum of the 11th Central Committee in 1978, when Deng Xiaoping led the way for the economic reform that transformed the country to what it is today.

The media coverage has been enormous, both prior and after the meeting, and the expectations of the reforms have been very high, even though they are, at this stage only concepts and it may take months or even years before any reforms actually comes in force.

China's Central Committee

The central committee is the highest authority within the communist party in China. It holds approximately 380 members, selected every five years, and the body appoints some of the most powerful figures in China, including the General Secretary, members of the Politiburo Standing Committee as well as the Central Military Commission.

Although the Central Committee does not exercise legislative reform as a corporate body, it is an important body in the sense that it contains the leading figures within the party, state and military and acts as a forum for where the party policy is discussed and decided on.

One example of this is the Third Plenary Session of the 11th Central Committee in 1978, with Deng Xiaoping leading the way for the economic reform that has transformed China to the economy it is today.

Striving towards a more open economy

If you would believe the communiqué, released only three days after the meeting ended on the 12th of November, the reforms or topics discussed will indeed reshape China in a significant way.

In short, China will strive to become a more open economy. This relates to the communiqué where the committee states that it acknowledges that markets will play a “decisive” role in allocating resources in the economy. This differs from the previous definition, released in the communiqué after the third plenum of the 14th Central Committee, where the markets had been defined as playing a “basic” role in the economy.

But what does this really mean and what can be expected with regards to reforms? According to professor Xie Chuntao, with the Party School of the CPC Central Committee, in an interview with the Chinese news agency Xinhua, the communiqué acknowledges the governments understanding of the true issues in today’s economy, where too much government interference have led to high administration costs, low efficiency and widespread corruption.

The government will try to build a unified market with orderly competition where businesses will be allowed to operate independently and compete fairly while consumers should be free to choose and spend – without too much government interference.

The proclaimed reforms can be summarized in the following five main themes: Financial, State Owned Enterprises, Land Rights, Welfare System and One Child Policy.

The first major reform blueprint by the new leadership, paves way for sweeping changes in the Chinese economy. But as often is the case with reform plans of this magnitude, tangible results are uncertain due to an uncommitted implementation time-table. In addition to this, the communiqué released after the meeting, is vague and does not specify in any further details how the reforms will be implemented.

However, several examples of reform have already been started, even before the third plenum took place - since the power transition in November last year the new central government has been pushing for institutional reform. In an effort to decentralize power and reduce administrative burden, the central government has already transferred 221 approval items to local governments. In addition to this, China’s central bank canceled the floor on lending rates in July and the launch of the Shanghai free trade zone is expected to provide a testing ground for the convertibility of the Chinese currency and the deregulation of the interest rates.

According to Xie, more reforms are expected as the communiqué over time transforms into explicit action plans.

Shanghai free trade zone

The new free trade zone launched on September, 29th, 2013, covers 29 square kilometers in Shanghai’s district Pudong.

Within the zone foreign currency exchange will be liberalized and banks will be able to set market interest rates which will be different from those in the rest of China. According to the government outline there will be six areas where industries will be opened during the next three years (Financial, Shipping, Commercial, Professional, Cultural and Social).

The zone is being seen as a testing ground for economic reforms in the country. When the concept of the zone turns out successful, expanding the new policies to the rest of China is possible. Furthermore, it has been advertised as the most important attempt at economic reform since the establishment of the country’s first special economic zone in 1980 in Shenzhen.

The project is a major part of Shanghai's drive to make itself an international financial center by 2020, and comes as China's ruling Communist Party tries to shift the country away from its long reliance on investments and exports, and more towards consumer demand.

Reforms Part 1

1. Financial Reform

The reform represents a move towards a less government controlled market, by opening up the banking systems and loosening the control on the pricing of water, electricity and natural resources, as well as improving the system for IPOs.

Since the government historically has notoriously intervened on financial markets; tightly controlling both exchange rates, interest rates and lending policy, the financial reforms listed in the communiqué is regarded as the most important/drastic.

Since the mid 1990's, fractional progress has been seen in the liberalization of the financial system. The banking system has been dominated by the large state owned banks and official lending has primarily only been available to State Owned Enterprises or very large privately owned companies. For a country with myriad small enterprises, so called shadow banking has been rampant in providing unofficial capital to the private sector. In addition to this, both interest rates as well as exchange rates have been tightly controlled by the government and IPO processes have been an impossible bureaucratic maze.

In the light of this, the government has stated that the financial reforms China will undertake within the near future will include better financial access for smaller companies, further trade integration, external opening-up (includes examples such as the pilot Shanghai Free Trade Zone which will act as a testing ground for exchange and interest rates liberalization) as well as allowing private investors to open banks. In addition to this, the government will ease the process of IPOs as well as let prices for oil, natural gas, water, electricity and other resources to a greater extent be affected by market forces.

2. State-Owned Enterprises:

Another key topic of the meeting has been regarding the administration of state owned assets, especially State Owned Enterprises, or SOEs. The reforms does not aim to wipe SOEs out of existence, on the contrary, the communiqué states that China's basic economic system is one that depends on public ownership as its main body but allows for the prosperity of various ownerships. Both public and nonpublic ownerships are important components and privately invested companies will be encouraged to play a more important role in the future of the Chinese economy.

Financial topics

The Chinese financial system is highly regulated and mainly mainly based on banking loans. Due to the government preferences for longstanding or large projects and large companies, China's banking loans have mainly flown to government-subsidized projects, State-owned or large-sized enterprises, and dominant traditional industries while leaving many small and less powerful companies, mostly privately-run, desperately hungry for funds. In addition to that the banking sector is also strictly regulated with six major banks which splitting almost half of the total loan-market, each having specific tasks and duties.

Moreover there is a tight governmental control regarding the pricing of water, electricity and other key resources have made these resources a source of major distortion.

Chinese regulators favoring state-controlled firms together with an extremely long listing process for IPOs has created a lot of frustration among investors

Reforms Part 2

Differing from the financial reforms, the topics related to SOEs came along with a more detailed approach for how the goal is to be achieved. Three main points were communicated through the communiqué; the government will set up a number of state owned asset management companies (to increase the transparency of their operations and ensure that they work in the public's best interest), by 2020 the dividends paid from SOEs to social security funds will increase from 0-20% to 30% and finally that private companies will actively be encouraged to participate in state investment projects.

3. Land Rights:

Up until now in China, according to the Land Management Law, rights to the rural collective land including farmland, woodland and housing land, has not been transferrable or leased for non-agricultural uses. The new land transfer policy may allow bidding, auction and listing of agricultural land. This may provide the land necessary for urbanization infrastructure. On the other hand, the new policy may also monetize farmland assets, adding extra spending power to rural population.

4. Improved welfare system:

China started its basic social security network in 2012, but has yet to achieve equality among all citizens. For instance, the country's 300 million or so migrant workers are entitled to social insurance in the cities where they work but still face obstacles in receiving the benefit if they leave their current jobs to work in other cities. Retirement insurance is also of prime importance, as some 500 million people — 35 percent of the population — will be aged 60 or older by 2050. Maintaining the value of the huge pension insurance fund, which affects the livelihoods of hundreds of millions, is another challenge for the government. This reform is a key step towards allowing free movement of labor, reducing the social welfare problems with migrant workers having to give up their entitled public services when moving to urban areas.

5. Eased one-child policy:

Since 1979 China has had the one-child policy. However the policy has been highly ambiguous with several loopholes for parents to use in order to be able to have more than one child. The communiqué does not elaborate exactly how the one-child policy will be reformed, only that it will be eased and that it will become easier for parents to have multiple children. At a time with fewer and fewer young people to secure the welfare for the continuing aging population, this reform is seen as a necessity.

State-Owned Enterprises

The economy of China is dominated by State-owned enterprises (SOE). These are companies owned by the local, provincial, and national governments. Today, the largest SOEs under direct government control normally pay five to twenty percent of their profits to the government in dividends.

Land rights

The Chinese government owns all the land and farmers are only permitted the right to work the soil in their area.

Welfare system

As of today, China's welfare system ties benefits like health care and pensions to a person's place of birth. Resulting in more than 200 million migrant workers not being able to access health care, pensions or education for their children in their host city.

One-child policy

Was implemented in order to control the population growth, required most couples living in urban areas to have one child. This policy has been relaxed later on and prior to the new reform, both parents had to be sole children to be eligible for a second child.

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“Curb your enthusiasm”

The communiqué, comprised of 5,000 words, referred to “reform” 59 times, “development” 37 times and what has been communicated through Chinese media is mostly positive recognition that the economy will change fundamentally towards becoming freer. However there are several, stakeholders who are less enthusiastic concerning the government’s ambitions – not that the reforms is moving the economy in the wrong directions, on the contrary, they will help to develop the country into a modern market economy, but rather what has been stated through the communiqué is unlikely to reform the economy so fundamentally. The simple reason being that most SOE’s – in their current position – have such a strong position and the barriers for private companies are very high.

Mostly the reform of privatizing the public sector will likely be about letting private players into a market run by SOE’s and not about actually privatizing existing SOEs, even if it were, few investors would have the financial strength to acquire companies of that size – the combined revenue last year of the 120 largest SOEs accounted for 43 percent of GDP.

After the release of the communiqué, the heading of a note from Bank of America’s Hong Kong based economist Lu Ting was “Curb your enthusiasm”. The heading speaks for itself of the view people on the outside have on the central government’s ambition.

According to Chang Jian, Honk Kong based economist at Barclays, reforms are more likely to improve the fiscal relationship between central and local government rather than to change the fundamental market characteristics we have seen in China for the last few years.

The expectations of what actual reforms will be formalized in the next few months aligning what has been stated in the communiqué are very high.

Public opinions

“Beijing has certainly talked the talk of changes and the hope is for the new leaders to walk the walk,” Societe Generale's economist Wei Yao

“Even when the top leadership does set out a clear framework, they’re not always able to push reforms through the system,” Timothy Beardson, author of Stumbling Giant – The Threats to China’s Future

“China is very much on the path of furthering market-led economic reform”, Shada Islam, policy director of the Brussels-based think tank Friends of Europe

China economists Jian Chang observed that economic growth tends to slow in the years following the Third Plenum meetings, which reflects the fact that structural reforms, while good for the longer term tend to slow growth in the short term

“The already opened door will never be closed again. Reform and opening up is a never ending process”, Xi Jinping, General Secretary of the Chinese Communist Party (CCP)

“While these reforms are a step in the right direction, the difficulty will be in the implementation given there are interest groups in government and in the state-owned sector whom will be resistant to change,” Jim Reid, macro strategist at Deutsche Bank

ASIA PERSPECTIVE

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