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QUICK REACTION

CHINA'S UNPRECEDENTED REFORMS WILL CHART A COURSE OF SUSTAINABLE GROWTH

The main document of the 3rd Plenum of the CPC named "The Decisions for Major Issues Concerning Comprehensively Deepening Reforms (the Decisions)" was released on Friday night. This document outlined the major policy reforms that will take place soon, which will have a major impact on China's economic developments in the next 5 to 10 years.

Overall, we believe the reform measures outlined in the Decisions are unprecedented and way above market expectations. China's top leadership pledged to remove the privileges granted to the state-owned enterprises, remove barriers to competition, use the markets to price factor prices, accelerate deregulation of interest rates and capital flows, lower curbs on foreign investment, reform the fiscal system and grant the local government the rights to issue bonds.

We believe all these reform measures will expand the role of the markets, enhance more efficient allocation of resources, and lift productivity growth. These groundbreaking reforms will substantially reduce the downside risks in China's economy. If implemented masterfully, we have no doubt China will return to a sustainable growth path. Indeed, a golden decade of sustainable growth and unparalleled prosperity has just started.

DETAILED REFORM MEASURES IN THE DECISIONS

Fiscal and Taxation reform

- China will establish a system whereby both central government and provincial governments should have financial resources to meet their duties and responsibilities. The central government is in charge of matters concerning national defense and security, foreign affairs, and the overall national market policies and management, while provincial affairs are overseen by local governments. Certain social security issues and cross-regional projects and maintenance will be shared by both central and local governments.
- China aims to create a standardized risk-warning system to better handle government debts. **Local governments are allowed to issue debt for their infrastructure financing.**
- China will deepen its reform on taxation, which includes improving the local taxation system, gradually raising the proportion of direct tax, advancing value added tax reforms and simplifying taxation. It will also step up legislation on property tax.

Implications

We believe these policy reform measures will broaden local governments' sources of income, which will reduce local fiscal risk and return local government finances to a more sustainable path.

The national audit of local government debt could be released by late November, and the results could reveal total local government debt of about RMB14trillion. At this stage, the local government debt is still manageable as the local governments still own a large amount of assets on their balance sheet.

We believe the policy to allow local governments to issue debt to fund their infrastructure programs will substantially reduce local government liquidity risk, and it is unlikely that local government financing vehicles will default *(For details, please see Is Chinese local government debt a big worry, ANZ Greater China Weekly Insight, 27 August, 2013).*

Banking and Financial reform

- China will accelerate yuan convertibility, liberalization of interest rate, capital account openness, and improve treasury yield curves to reflect market demand and supply.
- China will open up the banking sector further to allow qualified private capital to set up small and medium-sized private banks,
- The document acknowledged the China (Shanghai) Pilot Free Trade Zone as a significant move to push forward reforms and opening-up. The government will also select a number of other eligible locations to develop free trade zones.

Implications

One of the key financial reforms is to accelerate the process of interest rate liberalization. China has already removed the policy lending rate in July. While fully liberalizing interest rates may squeeze banking sector's profit margins, this will bring about a more market-driven banking system to encourage competition, thus improving the quality of financial services.

Another major goal of the reforms is to gradually open up China's capital account, achieving basic convertibility of the RMB by 2015. The Shanghai FTZ and Shenzhen's Qianhai will be allowed to experiment with floating deposit interest rates and full convertibility of the RMB exchange rate (For details, please see Will the Shanghai Free Trade Zone accelerate China's financial and capital account liberalization, ANZ Greater China Economic Insight, 3 September, 2013).

Population policy

- The Party pledged to relax China's one-child policy and couples will be able to have two children if either parent is from a single child family.
- Meanwhile, the policy to increase retirement age will be studied and rolled out at appropriate time.

Implications

We estimate that the mildly modified "two-child policy" is unlikely to result in a baby boom in the medium to long term. Our study shows that the increased number of newborns will range from 9 to 15m in the next decade. While the increased consumption will be quite small till 2020 (less than 0.1% of nominal GDP), long-term benefits are considerable: By 2030, the increased household consumption will be around 0.3-0.45% of nominal GDP.

Regarding the growth prospects, while the new born babies will enter the workforce in about 15-20 years if the two-child policy were to be implemented in 2014, the downward trend in China's labour force will not change, but the pace will be delayed somewhat, giving policy makers breathing room to engage in education reform to enhance human capital and pension reform (For details, please see China's one-child policy: time for a change, ANZ Greater China Weekly Insight, 19 September 2013).

Administrative Reform, Bureaucratic Restructuring & SOE Reform

- Investment projects, except those concerning national security, eco-safety, strategic resource exploitation or vital public interest, will be determined by enterprises in accordance with the law and without any need for government approval. China will adopt a negative list approach to market entry. **China will explore adopting an approach of national treatment, plus negative list, in regulating foreign participation in domestic market.**
- China will promote market-oriented reform in state-owned enterprises (SOEs) by introducing competition and further breaking up monopolies.
- The Decisions also urge further improvement in the management of state-owned assets. Priority will be given to better supervised state-owned capital. Certain qualified state-owned enterprises (SOEs) will be reorganized and transformed as state-owned assets investment companies.
- Part of shares of state-owned capital will be transferred to the national social security fund. State-owned enterprises are required to hand over 30% dividend payments to the state by 2020, and the dividends will be used for social welfare spending and improving peoples' livelihoods. At present, the proportion ranges from zero to 15%.
- There should be a clear separation between the state and state-owned enterprises, and that between the state and state-owned capital, so as to reduce the influences of SOEs in central and local government decision making and facilitate the state's regulatory role.
- China will push forward pricing reforms for water, oil, gas, power, transportation, telecom and other sectors, and give the markets the decision-making power in allocating resources.

Implications

In the past, the demarcation between the state and state-owned enterprises had been blurred, making it difficult for the government to function as a regulator because of heavy SOE influences and lobbying. We believe the policy intention here is for the government to concentrate on its regulatory role through the establishment of an arms-length relationship between the state and SOEs. By reducing administrative red *tape and unnecessary interferences in business, even official corruptions could be reduced and private sector confidence could be boosted.*

Certain administrative reforms have already started. Premier Li earlier vowed to reduce existing items required for administrative approval by at least one third in the coming five years. Factor price reform is another concrete measure to promote the market's role in the economy. Starting from early this year, China's NDRC has changed the oil pricing mechanism to closely reflect market prices. We believe such price reform could be quickly replicated in other sectors.

Competition will be encouraged and efficiency will be enhanced by lowering entry barriers and reducing monopoly power. Therefore, economic dynamism will re-emerge with renewed confidence among both Chinese private enterprises and foreign companies alike.

Land reform, Household registration reform (hukou) and Urbanization

- China will accelerate the hukou reform. The hukou system in small cities will be fully liberalized, while the hukou system will be relaxed in an orderly manner in medium-sized cities. For large cities, the government intends to contain the existing size of the population while implementing proper rules to facilitate the settlement of migrants.
- Farmers' rights to contract and manage their leased land from the state and their right to residential housing land will be better protected, while the transfer of farmer's land for residential use will be steadily implemented with trial programs.
- The reform also aims to ensure that migrant workers receive equal income as their urban counterparts and people in rural areas equally share the benefits from the incremental values of land.
- Under the unified system to drive urban-rural integration, educational resources will be evenly distributed; pension, medical insurance and basic living insurance programs will be coordinated, and basic social services in cities and towns will cover all migrant workers from rural areas.

Implications

Land reform and household registration are two key issues if China is to succeed in its plan to push forward urbanization. The lack of clear land rights had made many farmers vulnerable to land grabs by local administrations in the name of economic developments, leading to rampant local corruption and mass demonstrations.

We believe the rights given to farmers permitting their land leased to be transacted in the markets will allow farmers to capitalize on their land ownership, encourage agri-business and corporate farming, improve rural income, and facilitate China's urbanization.

The current hukou system has been a big impediment to China's urbanisation. Our study shows that China's urbanisation number is much lower if we use the criteria as to whether migrants living in urban areas can have equal access to urban public services. Using this definition, we find that China's urbanisation could be over-estimated by as much as 15% *(For details, please see The myth of China's urbanisation, ANZ Greater China Weekly Insight, 15 January, 2013). The de-linkage between hukou and the public services is the key for this reform.*

Breaking the hukou reform also suggests that China will have to invest more in public services in the future in order to satisfy the needs of all its urban dwellers. This means, in addition to hard infrastructure investment, China's urban areas will also experience an investment boom in public school, hospitals, and other public services associated with fast migration process in China's tier II, III, IV cities. .

Income distribution, Social safety net and Social equality

- China will enhance regulation of secondary income distribution through taxation. The country will meanwhile focus on increasing the share of work remuneration in primary distribution.
- Society-wise pension planning and individual accounts will be core of China's basic pension system, and a mechanism that gradually increases retirement age will be explored and mapped out.
- The management of personal pension accounts will be improved to encourage more input for higher annuities while protecting pensioners' interests.

- The CPC vowed to "positively cope with the aging population issue" by accelerating the development of elderly service industries. A care service network will be improved for rural children left behind by their parents as well as for women and the elderly in rural areas.
- The urban-rural retirement system and medical insurance systems will be coordinated, and a new system will be set up to review and improve the social security conditions of people from all walks of life.

Implications

The key reason Chinese save so much and consume so little is because of a lack of adequate social safety net. As a result, ordinary Chinese citizens have a high precaution-saving motive. They will need to keep money for the future - for medical emergencies, for children's educational expenses, for their retirement.

In this case, rebuilding the social safety net is important to release the potential of China's household consumption, thus sustaining the growth path in the medium term. In addition, the portability of social benefits will increase the mobility of the labor force, thus enhancing the vitality of China's labor market.

Further legal reform and Judiciary independence

- China will abolish the "reeducation through labor" system as part of a major effort to protect human rights. The controversial correction system, commonly known as "Laojiao," began in the 1950s. The program usually takes in minor offenders whose offence is not severe enough to take them to court.
- The document also emphasizes the authority of China's Constitution, allows more judiciary independence to better enforce the rule of law and ensure social justice, and improves the protection of human rights via the legal system.

Implications

We believe a society built on the rule of law can only ensure the smooth operation of a market-based economy. These legal reforms are a step in the right direction to improve protection of citizens' property rights, human rights, and their other constitution granted rights so as to reduce social conflicts and tensions.

Two institutions to ensure the implementation of reforms and mitigate risks

- The setting up of a Central Leading Group to Deepen Reforms intends to reduce bureaucratic infighting and ensure a systemic implementation of reforms. Partly recognizing that vested interest groups have become very powerful, the Chinese authorities would like to centralize China's reform process. This leadership group will also be above technical ministries so all policy reform measures could be better coordinated. To some extent, this leadership group could set policies for the State Council to execute, thus enabling the new leadership to cut through bureaucratic red tape so as to push forward tough reforms. We believe China's reforms in all areas will be more focused and centralized at the top given many reforms have become too complex with implications at the national and even international level. It is therefore more difficult to execute reforms using an experimental or piecemeal approach.
- Establishing a National Security Council, similar to the one in the US, is intended to help top leadership better coordinate China's national security policy by monitoring the risks facing the economy and national security. We think its scope goes beyond a narrow interpretation of traditional security issues such as national defense and public security only. The council will also look at China's non-traditional security issues such as food, energy, financial stability, and others. To some extent, the role of line ministries could be reduced, making them functional bureaucracies. We believe this Council could make China's future policy framework consistent with its role in the global economy.

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