China’s supply-side structural reforms: Progress and outlook

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Executive summary

Supply-side structural reform (SSSR) dominates the economic policymaking landscape in China. In place for more than a year, the policy shapes everything from the government’s efforts to reduce excess industrial capacity to initiatives designed to curb high levels of corporate debt, such as debt-for-equity swaps. Evaluating China’s ability to overcome its chief economic challenges and sustain its economic growth is impossible without having a proper grasp of SSSR.

In this white paper The Economist Intelligence Unit provides the first comprehensive, independent analysis of the programme. Our starting point is that SSSR is not just a government slogan, but something that ought to be subject to sober analysis under its own terms. The five components of SSSR – cutting excess industrial capacity, destocking property inventory, corporate deleveraging, lowering corporate costs and improving “weak links” – are dissected, in turn, in the paper.

Among the key takeaways for businesses:

● We expect slower progress on coal and steel industrial capacity cuts, potentially applying downward pressure on commodity prices. Capacity reductions in 2016 involved a significant amount of idle capacity and were concentrated in the private-sector; they have yet to extend meaningfully into productive capacity or the more sensitive state-owned enterprise (SOE) sector. The drive against overcapacity might also be extended to sectors including automobiles, new materials and renewable energy.

● Efforts to destock property inventory will likely have a fairly marginal impact. Investor unease and slow progress on key reforms make it difficult to stimulate demand across smaller cities. Efforts to restrain supply are complicated by the dependence of local governments on land sales revenue; a property tax is unlikely to come in force before 2020.

● Some of the deleveraging schemes backed by the authorities, such as debt-for-equity swaps, are problematically structured and may not achieve that much in terms of meaningfully reducing corporate debt. More important will be pushing a productivity reform agenda, especially among SOEs.

● Companies will benefit from lower effective tax rates, with the government set to ease burdens associated with administrative charges and social security. However, we do not expect a broad cut in the corporate tax rate and the introduction of the Environmental Protection Tax in 2018 will create significant additional costs for industrial firms.

● Strong government support for innovation under strengthening “weak links” and the Made in China 2025 initiative will provide local firms with resources and capital to help their transition up the manufacturing value-chain, to the likely detriment of foreign players. There are inefficiencies associated with this top-down approach, however, and in terms of innovation, private technology companies will play a bigger role in the transformation than state-owned firms.

SSSR’s close association with the Chinese president, Xi Jinping, means it is likely to shape economic policy for many years to come. Companies and investors need to monitor the development of the policy carefully if they are to be alert to both opportunities and risks in the Chinese business landscape.
Introduction

Supply-side structural reform (SSSR) has emerged as the main economic policy framework in China. It informs the government’s approach to the challenges facing the economy, such as massive industrial overcapacity, a frothy property market and dangerously high levels of corporate debt. To a significant extent, SSSR has superseded the reform blueprint set out by the ruling Chinese Communist Party (CCP) in November 2013, which called for the market to assume a “decisive” role in allocating resources by 2020.

SSSR ought to be central in any analysis of China’s economic prospects, but surprisingly little attention has been given to it by independent research organisations. The Economist Intelligence Unit aims to fill that gap in this white paper. We describe the main components of SSSR; evaluate what progress has been made in meeting its aims; and offer our views on how the initiative might evolve, including which elements of the policy are more likely to succeed than others. Our analysis is based on a rich understanding of the Chinese policy environment and access to comprehensive economic data, combined with interviews with several local policymakers and academics.

Origins and definitions

SSSR was first mapped out in December 2015 at the Central Economic Work Conference (CEWC), a high-level annual meeting of policymakers and senior CCP leaders, including the president, Xi Jinping. The conclave noted that SSSR would help to “guide the new normal”, a phrase coined by Mr Xi after he took over leadership of the CCP in 2012 to refer to an anticipated period of slower economic growth.

The starting point for SSSR was recognition in official circles that Keynesian demand-side policies had run their course. Years of boosting the economy with monetary and fiscal stimulus had given rise to structural imbalances and financial risks. Easy credit had caused “zombie companies” to proliferate in overcapacity industries; the financial system was exposed to a massive property overhang caused by overinvestment; and domestic firms were not producing the goods and services demanded by local consumers.

SSSR is meant to wean the economy off its dependence on stimulus, helping to drive growth by unleashing latent productivity. It aims to curtail supply in some areas, while making adjustments in regulations and markets to incentivise companies to invest more in producing what is actually in demand. The 2015 CEWC identified five areas of focus under SSSR, known in Chinese as the “three cuts, one reduction, one strengthening” (三去一降一补):

1. Cutting (industrial) overcapacity
2. Destocking (property inventory)
3. (Corporate) deleveraging
4. Lowering corporate costs
5. Improving “weak links”
There is some resemblance between SSSR and classic supply-side economics, as understood in the West. The emphasis on reducing corporate costs bears comparison with the programme of tax cuts and deregulation backed by a former US president, Ronald Reagan, in the 1980s (often dubbed “Reaganomics”). Mr Xi’s principal economic policy adviser and the chief protagonist behind SSSR, Liu He, received some of his education in the US.

Such comparisons ought not to be stretched too far, however, as SSSR is broader and more inchoate. It contains a mix of different policies that run across various areas of the economy and envisages a strong role for the state, including in fostering industrial innovation. The context also differs, with Reaganomics formed to counter “stagflation” (low growth and high inflation), while SSSR is mainly concerned with fighting deflationary pressure. To make the distinction clear, in a speech to officials in January 2016 Mr Xi warned against those using SSSR as an excuse to promote “neoliberalism”.

**Right diagnosis, wrong treatment?**

Officials are not misguided in their identification of the economic ills that trouble the economy. Less clear is whether the methods adopted by the government under SSSR are the best means of addressing those problems. To answer that question, in this white paper we provide detailed analysis, in turn, of the five areas set out under SSSR at the 2015 CEWC and how policy is developing in each of those fields.

What is clear is that a grasp of SSSR is critical to evaluating prospects for China’s economy. The December 2016 CEWC reiterated the importance of SSSR, in a sign that the policy—closely associated with Mr Xi—is here to stay. Whether it can relieve the economy of its structural challenges and deliver sustainable, long-term growth remains to be seen.
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I. Cutting industrial overcapacity—the great leap in reverse?

The Great Leap Forward (1958–62) represented a monumental, if tragically flawed effort, to modernise China’s economy—partly by mandating massive rises in steel production. Today, the government is backing a campaign that aims to do exactly the opposite. Reducing overcapacity across industrial sectors holds primacy within SSSR and has dominated economic policy efforts since the beginning of 2016.

More urgency in 2016

China’s most recent drive against industrial overcapacity comes after a long period of failure to cut excess capacity in sectors such as cement, coal, glass and steel. Underpinning this was the reluctance of local officials to close underperforming firms that provided employment and tax revenue. The huge release of bank credit in the wake of the 2008–09 global financial crisis also provided enough funds to help to sustain these firms.

The task of cutting overcapacity assumed more urgency in 2016. For years the authorities had tolerated expansions in capacity across a variety of industries, despite capacity utilisation rates dipping below 75% (normally a threshold for indicating a balanced relationship between supply and demand). Yet the formulation of the SSSR agenda signalled greater imperative behind this drive.

The simple answer for this shift in priorities is that cuts could no longer be delayed: the negative externalities associated with excess capacity had become too severe. Eroding bank asset quality was...
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an especially important driver. So-called zombie companies were clustered in overcapacity sectors, especially coal and steel. A decline in prices after 2011, in part precipitated by overcapacity, prompted several years of slowing – and eventually declining – profit growth and leverage levels rose sharply.

By end-2015 the coal and steel industries accounted for around 14% of corporate debt within the industrial sector. Based on the annual profits of the coal and ferrous-metal (including steel) smelting industries in 2015 it would take 91 years and 74 years, respectively, to pay back total debts, compared with an industrial sector-wide average of under 10. This also acted to squeeze out loans available for emerging industries and profitable firms.

The environmental cost of pollution linked to heavy industry was also giving rise to social unrest. Furthermore, exports of products from overcapacity sectors were generating tensions in China’s international trade relations. Lastly, it was increasingly apparent that investment growth had entered a secular slowdown, rather than a cyclical blip.

**A successful kick-off**

The State Council (the cabinet) issued two documents to guide production cuts in February 2016, settings targets for reducing steel and coal production capacity by 45m tonnes and 250m tonnes respectively in the year. Within “three to five years”, the government said that it wanted to have reduced capacity by 100m-150m tonnes in steel and 1bn tonnes in coal.

In contrast to earlier efforts, the government claims that it was successful in cutting capacity in 2016. It has said that 65m tonnes of steelmaking capacity and 290m tonnes of coal capacity were cut in the year, comfortably exceeding the targets. It can also point to the cuts made and to improved financial conditions in the two sectors. From a low base, profits in the ferrous-metal smelting and coal mining industries jumped by 115.7% and 47.8%, respectively. A commodity price surge in the second half of the year, partly driven by supply shortages, drove higher profits.

Although most provinces met their capacity reduction targets in 2016, a handful fell short. Anhui province did not even meet its 2016 target of 7m, suggesting that its medium-term plans may be too ambitious. Inner Mongolia’s coal capacity reduction, albeit in line with the annual target, was notably modest given its status as the country’s second-largest producer. This may relate to the fact that mining resources in the region have higher potential, as they are relatively unexploited. Several provinces also reached their annual targets only by accelerating reductions in the fourth quarter of the year, amid mounting pressure from the central authorities.

**Capacity cuts will become tougher**

We believe that this early success will not be easy to replicate in the coming years, however. The government also appears to share a similar view: official capacity reduction targets for steel and coal in 2017 have been lowered from last year to 50m tonnes and 150m tonnes, respectively.

The main reason for our scepticism is that the price rebound in late 2016 will make companies and local governments reluctant to cut capacity. The majority of the cuts in 2016 consisted of already-idled capacity; it will be much more difficult to cut operating capacity, especially with profit growth returning. The Rmb100bn (US$14.3bn) restructuring fund set up by the central government at the
beginning of 2016 to facilitate the process has also been poorly deployed, with a third of it already dispersed to cutting capacity attached to failing zombie firms. This gives little room to support the restructuring of better-performing companies.

Our view is reinforced by the fact that capacity cutting has not yet extended to the politically more
challenging areas in the state-owned enterprise (SOE) sector. The cuts to date have focused on the private sector. Private firms tend to be more vulnerable to government-led closures because of a lack of legal protection and weaker political connections. As an example, we estimate that state-owned Hebei Steel Group, the largest iron and steel producer in Hebei province, shuttered 9.4% of its production capacity in 2016—but it ought to have been around 15% if it was cutting at the same pace as the province as a whole.

The reluctance to push cuts in the SOE sector reflects several factors. It would have more significant consequences for the financial system, as banks would be forced to absorb a high volume of non-performing loans (NPLs). SOEs are less efficient than their private-sector counterparts and have been more reliant on debt to fund their operations. The implications for social stability are also more sizeable, given the large workforces attached and often large pension liabilities.

Another reason why we expect cuts to proceed more slowly is that reductions in supply may complicate other economic objectives. Higher steel prices, on the back of further supply reductions, could undermine plans to maintain infrastructure spending at a high level. Low prices have helped to underpin strong infrastructure investment in recent years, but without this support to profitability the attraction of infrastructure projects—especially to private firms under much-promoted public-private partnerships—may be less apparent. We estimate that infrastructure investment represented around 19.6% of fixed-asset investment in 2016; several provinces are targeting significant rises in investment in 2017.

Hardening budget constraints

The broader concern is whether the cuts are substantive enough to have a positive economic impact. In this sense the main worry is that market forces are playing little role in driving the direction or scale of capacity reductions; rather, to date it has been a top-down process led by the central authorities. Little information has been provided over how the targets are settled or justification provided over their geographic remit. In some cases, provinces are competing to show their determination to implement cuts, in an effort to secure goodwill from the central authorities and the receipt of restructuring funds.

Without the discipline provided by the market, there is a significant risk that the cuts will be implemented imperfectly, disproportionately affecting the more efficient private sector and with potentially adverse consequences. Indeed, the surge in coal prices in late 2016 ought to caution about the wisdom of taking a top-down approach to the problem.

The root of the overcapacity problem lies in continued credit support, either in the form of government guarantees or from local banks, for inefficient firms mainly in the SOE sector. Until hard budget constraints are imposed on such entities, overcapacity will persist. Admittedly, defaults in the corporate bond market, including among SOEs, have become frequent and bankruptcy filings rose by more than 25%, to nearly 40,000, in 2016. However, the authorities will have to tolerate much higher levels of failure if overcapacity is to fall meaningfully. Unfortunately, the systemic importance held by such large companies means that local governments will be reluctant to permit this. More mergers are likely between SOEs in 2017, but if officials force strong firms to absorb loss-making mills, instead of shutting them down, they are likely to create bigger, weaker companies.
The other concern with the drive against overcapacity is its limited scope. The government has targeted steel and coal to date because, besides the financial and environmental factors, they are the most vivid representations of old, outdated industry. Yet the overcapacity problem stretches far beyond those sectors. We estimate that industries in 2015 with production capacity utilisation rates lower than 75% included cement, household appliances, machine tools and tobacco.

Without the market playing a bigger role, efforts to cut industrial overcapacity will prove suboptimal. At present, reducing steel and coal capacity has become a political task and has so far been implemented relatively effectively. But if political will behind the drive was to ebb, in the absence of underlying changes to banking, pricing, subsidy policies and market-entry criteria, then excess supply will persist.
II. Destocking property inventory—deflating the bubble

Clearing a massive stock of unsold housing is one of the major challenges facing the economy. The “destocking” component of SSSR is aimed mostly at this objective. It is complicated by wide variations in the market. Property inventories are uneven among city tiers, with little excess supply in first-tier cities but large stocks piling up in lower tiers. The authorities are currently trying simultaneously to tighten house buying in major cities where prices have risen rapidly, while coaxing buyers into smaller cities that offer little in terms of jobs and modern lifestyles.

Box: Our definition of city tiers

We divide China’s cities into four tiers, based on the size of their economy and political influence. Tier one includes the four largest metropolitans: Beijing (the capital), Shanghai, Shenzhen and Guangzhou, where housing demand is most robust. Tier two includes most provincial capitals and larger cities. They are usually the economic or political centre of the province. Tier-three cities are smaller in economic and political influence, but usually with a high proportion of mid- to high-income consumers. Tier-four cities are further down in economic development, but still populous.

Characteristics of city tiers, 2016

<table>
<thead>
<tr>
<th></th>
<th>Tier one</th>
<th>Tier two</th>
<th>Tier three</th>
<th>Tier four</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of cities</td>
<td>4</td>
<td>33</td>
<td>91</td>
<td>158</td>
</tr>
<tr>
<td>Average real GDP growth (2030 forecast)</td>
<td>7.6%</td>
<td>7.7%</td>
<td>7.7%</td>
<td>6.6%</td>
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<tr>
<td>Average GDP (Rmb bn) (2030 forecast)</td>
<td>2288</td>
<td>811</td>
<td>277</td>
<td>98</td>
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<tr>
<td>Urban disposable income (Rmb) (2030 forecast)</td>
<td>4907</td>
<td>1743</td>
<td>577</td>
<td>198</td>
</tr>
<tr>
<td>Urbanisation rate (2030 forecast)</td>
<td>51721</td>
<td>40480</td>
<td>31600</td>
<td>27202</td>
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<tr>
<td>Middle class* (% of population) (2030 forecast)</td>
<td>121008</td>
<td>90247</td>
<td>69306</td>
<td>58829</td>
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<tr>
<td>Population (‘000) (2030 forecast)</td>
<td>43%</td>
<td>24%</td>
<td>12%</td>
<td>9%</td>
</tr>
<tr>
<td>Average migration inflow (‘000) (2030 forecast)</td>
<td>72%</td>
<td>52%</td>
<td>29%</td>
<td>22%</td>
</tr>
<tr>
<td>Urbanisation rate (2030 forecast)</td>
<td>90%</td>
<td>72%</td>
<td>52%</td>
<td>46%</td>
</tr>
<tr>
<td>Population (‘000) (2030 forecast)</td>
<td>18651</td>
<td>9034</td>
<td>5163</td>
<td>2685</td>
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<tr>
<td>Average migration inflow (‘000) (2030 forecast)</td>
<td>9411</td>
<td>306</td>
<td>226</td>
<td>87</td>
</tr>
<tr>
<td>Average floor space started (‘000 sq metres) (2030 forecast)</td>
<td>306</td>
<td>226</td>
<td>87</td>
<td>50</td>
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<tr>
<td>Average housing price** (Rmb) (2030 forecast)</td>
<td>56</td>
<td>47</td>
<td>19</td>
<td>10</td>
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</table>

Sources: The Economist Intelligence Unit; WIND; CEIC.

Note: *We define middle class as those with annual disposable income of more than Rmb40,000 (US$5,700); adjusted by grey income.

**Average housing price refers to the January-November 2016 average for 100 representative prefecture cities.
Slightly less inventory, much higher prices

Based on our estimates, at end-2015 total unsold property inventory across the 286 prefectures in our dataset was more than double that in 2011, reaching 541m sq metres. Over that period the bulk of the inventory growth occurred in the lower-tier cities. In 2011-15 tier-four cities’ inventories grew by 152%, followed by tier two (+142%) and tier three (+112%), while tier-one cities saw growth of 38%. As a result, tier-one cities accounted for 9.7% of total inventories in 2015, tier two for 41.6% and tiers three and four for the remaining 48.7%.

**Total inventory estimates by tier, 286 prefectures**

<table>
<thead>
<tr>
<th></th>
<th>First tier</th>
<th>Second tier</th>
<th>Third tier</th>
<th>Fourth tier</th>
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<tr>
<td>2011</td>
<td>38</td>
<td>47</td>
<td>116</td>
<td>43</td>
</tr>
<tr>
<td>2012</td>
<td>43</td>
<td>50</td>
<td>160</td>
<td>45</td>
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<td>2013</td>
<td>45</td>
<td>61</td>
<td>203</td>
<td>50</td>
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<tr>
<td>2014</td>
<td>50</td>
<td>81</td>
<td>225</td>
<td>52</td>
</tr>
<tr>
<td>2015</td>
<td>52</td>
<td>99</td>
<td>165</td>
<td>50</td>
</tr>
</tbody>
</table>

Sources: The Economist Intelligence Unit; CEIC.

Note: Although the government data agency, the National Bureau of Statistics (NBS), provides a national figure for unsold property, this is not broken down comprehensively at city level. We used NBS survey data on unsold floor space across 35 representative cities to generate an estimate for average inventory per head. We then multiply inventory per person by the estimated metropolitan population to obtain total inventory across the 286 prefectures within our data coverage. Metropolitan population is an existing estimate from The Economist Intelligence Unit that refers to the population living in the contiguous urban area (it excludes mainly rural districts of cities).

The authorities took blunt measures to reduce property inventories in 2016. The inclusion of property “destocking” in SSSR was a powerful signal to the market, especially as it came after a series of interest-rate cuts in 2014-15 that had lowered mortgage financing costs. A tepid stockmarket and tighter controls over capital outflows also encouraged investors to focus on domestic property assets. Buoyed by these factors, sales of commercial property (including residential housing) rose nationally by 22.5% in 2016, to nearly 1.6bn sq metres, with prices soaring in some cities.

Although this surge in sales was strong enough to reduce unsold inventory for the first time in many years, the scale of the fall was modest at 3.3% from end-2015, underlining the scale of the challenge. Across the country, property inventory still stood at nearly 700m sq metres at end-2016, compared with around 365m sq metres at end-2012, according to the NBS.

The approach taken by the authorities also had unintended consequences. Rather than interpret the SSSR agenda as the government might have intended, buyers instead flocked to first- and a select number of second-tier cities. Indeed, concerns about the property overhang across lower-tier cities, partly prompted by government warnings over the issue, encouraged a flight to quality, with investors...
instead prizing “safe” property assets in the largest cities. As a result, little progress was made in reducing unsold inventory across smaller cities, where the problems are most severe.

Housing price trends varied widely across city tiers. Using a weighted average based on the 70-city price index for new housing compiled by the NBS, we estimate that house price growth across first-tier cities reached a peak of 29.2% year on year in September 2016. Meanwhile, tier-two city house prices were up by a weaker 16%, third tier by 4.7% and fourth tier by 1.5%. The performance of lower-tier cities tends to lag that of the first tier, but the wider spread in prices last year looks unusual compared with past cycles. In tier-one and some tier-two cities, housing price appreciation has exceeded the growth of urban disposable income since mid-2015.

**New-house prices by tier**

(% change, year on year; weighted av)

Concerned about the scale of house price inflation in first-tier cities, the government began implementing tougher tightening measures in October 2016, including stricter rules on house buying and mortgage financing. At the December 2016 CEWC officials pledged to deflate several asset price bubbles, including in property, noting that houses are “built to be inhabited, not for speculation”.

**Tackling lower-tier inventory**

The priority for policy in 2017 and beyond will be to encourage non-speculative demand for housing across lower-tier cities, without releasing speculative forces that might stimulate rises in prices across all tiers.

The approach will consist of tighter supply-side management. As part of the tightening measures introduced in October 2016, developers were restricted from financing through the equity and bond markets in mainland China and Hong Kong. Provinces also have plans. For example, in 2016–18 the western municipality of Chongqing plans to reduce urban land supply by 10% annually, limit new construction area growth to within 3% and encourage the conversion of commercial housing to parking garages.
In terms of managing demand, however, policies are likely to diverge. The first- and second-tier cities will probably maintain restrictive household registration (hukou) policies, alongside retaining higher down-payments for a second house and the restrictive rules on the minimum number of years of paying personal income taxes and social security that are required before buying a home. A long-discussed property tax to curb speculative purchasing also appears to have more momentum, but will probably not be implemented until 2020 at the earliest. A major barrier to the tax remains asset disclosure by officials.

Yet for third- and fourth-tier cities, house purchasing policies are likely to remain loose. Local authorities in such regions have already relaxed hukou rules, lowered down-payment requirements and cut property transaction taxes. Cities in provinces such as Anhui, Henan and Liaoning also provide discounted mortgage loans for migrant workers, university graduates and low-income buyers.

Encouraging migrant workers to purchase homes in third- and fourth-tier cities close to their rural abodes is a particular focus of government policy. Our estimates suggest that in 2016 there were about 16m migrants living in such cities, representing a potentially sizeable source of demand. The central authorities have rolled out a three-year plan (covering 2015-17) to transform “urban villages” in the city into low-cost housing for migrant workers. However, as these urban villages are not currently included in official inventory estimates, success in this area will not necessarily mean a reduction in existing stocks.

The challenge also rests on financing house purchases across low-income groups. Lacking high levels of income, migrants from rural areas will find it difficult to obtain mortgages from banks. Rural land reform and giving migrants the right to sell farmland at a market-based price will help them to afford down-payments. Progress on rural land reform has been frustratingly slow, but some promising pilot programmes are in place in parts of the country.

More encouragingly, internal migration patterns are shifting in a way that might help the destocking agenda. The relocation of industrial capacity to inland regions, as well as the obstacles posed by high living costs in tier-one cities, appears to be encouraging migrant workers to stay closer to home. By our estimates, in 2016 net migration inflows, although remaining positive, declined by 12% in tier one, 45% in tier two and 9% in tier four. Only tier-three cities saw a rise in net migration inflows against the previous year. According to the local government, Shanghai—once a magnet for migrant workers—recorded a decline in its total population last year.

**A challenging outlook**

Weaning the economy off its dependence on the property market will be challenging. Restricting new housing construction runs directly against the interest of local governments. They are heavily dependent on land sales as a source of fiscal revenue and view rising house prices as an opportunity to step up their auctioning of land. Cooling property development would directly affect GDP growth and the labour market, as well as generate risks for the financial sector because of its exposure to debts held by developers. Property is also the main store of household wealth.

Meanwhile, stimulating real demand for lower-tier property rests on a complicated set of reforms. Land reform will be a crucial element. Property rights also have to be placed on much firmer ground,
with some residential property leases set to expire in the coming years.

The government’s commitment to destocking will therefore be tested once economic growth softens again, probably in 2018. If it reverses course on the measures that it took in 2016 to cool the market, the property bubble will build again and become even more divorced from fundamentals such as income and demographics. Ensuring that the bubble does not burst would probably require also that the authorities do not make any bold moves to liberalise capital markets or overseas investment flows in order to ensure that domestic savings remain captive. This would act as a drain on long-term economic growth and restructuring.
III. Corporate deleveraging—curing credit addiction

The focus of SSSR on corporate deleveraging is welcome, albeit overdue. The agenda set out by the authorities to tackle the problem contains positive elements, although clarification is needed on several of them. The programme that has attracted the most attention—debt-for-equity swaps—also appears less promising for deleveraging on close inspection.

Leveraging up

China’s economic growth became worryingly credit-intensive after the 2008-09 global financial crisis. By end-September 2016 China’s non-financial sector debt had reached Rmb185.6trn (US$28trn), equivalent to 255.6% of nominal GDP, according to the latest data from the Bank for International Settlements (BIS). The ratio was not far below the BIS’s reported aggregate ratio for advanced economies at that time (279.2%) and far above the average of emerging markets, excluding China (186.5%).

Most concerning in China’s case is the rapid rise in leverage: debt stood at Rmb45.1trn at end-2008 and the debt-to-GDP ratio was a much healthier 141.3%. The rise in leverage levels reflects huge growth in credit issuance, alongside relatively weak nominal GDP expansion, suggesting that bank lending was not generating economic activity as efficiently as it did in the past. Rapid increases in debt over a short period of time have tended to place a country’s financial sector under dangerous strain, as evidenced by Japan in the 1990s or the US and European countries in the 2000s.

Debt-to-GDP ratio of selected countries

Sources: Bank for International Settlements; The Economist Intelligence Unit.
Corporate-sector debt is the greatest concern and the main priority within the SSSR deleveraging agenda. Corporate debt accounted for 65% of total debt at end-September 2016, according to the BIS, and was equivalent to 166.2% of GDP. SOEs are the major contributors, with their liabilities representing around 70% of the total corporate debt load based on local data.

The most conventional method of corporate deleveraging consists of tightening monetary policy in order to discourage companies to take on additional debts, while also nudging them to refinance in the equity market than the debt market. Yet this might not work well in China, as the structure of bank lending is different to many developed markets. Banks prioritise loans to SOEs above the private sector, as the government’s implicit backing of the former is seen to make them less risky. Historically, credit tightening has tended to affect private firms first, despite their higher levels of efficiency and ability to generate more GDP per unit of debt. A period of credit tightening, if not accompanied with reforms to improve loan allocation, would therefore place more downward pressure on economic growth than might be assumed.

This is why conventional monetary policy tightening is not central to the programme that has taken shape around corporate deleveraging in China. Growth in credit supply has slowed: broad money supply (M2) expansion eased to 11.3% at end-2016, from 13.3% at end-2015. In early 2017 the People’s Bank of China (PBC, the central bank) implemented small increases in some of the interest rates that it charges on lending facilities it uses in its open-market operations. However, the PBC has refrained from increasing its benchmark one-year deposit and lending rates since they were cut to a record low in October 2015.

Instead, the government is backing a mix of policies in an effort to ease the corporate debt strain. These were set out in a document released in October 2016 by the State Council. It features seven main initiatives: encouragement of mergers and acquisitions (M&A); reforms in corporate governance; increased securitisation; improvements in debt structure; debt-for-equity swaps; permitting more corporate bankruptcies; and encouraging equity financing.

Another form of leverage? Debt-for-equity swaps
Outside China, debt-for-equity swaps have been used to facilitate debt restructuring if a company is in financial distress. The transaction will involve two parties: the lender and the company in trouble, with the company offering the swap to the financial market and lenders deciding whether they would accept it. The swap can be done at face value or at a discount, depending on the financial market and the company’s specific situation.

The swaps have been set up differently in China, however, where they involve three actors: an indebted company, a bank or pool of banks holding the company’s debt, and an “implementing fund”. The implementing fund will raise money from wealth-management products (WMPs) and social capital (insurers, pension funds) to purchase debt from the bank(s). It will then negotiate a swap of this debt for part of the company’s equity.

In theory, banks will have the authority to find target companies and negotiate the terms. However, there are likely to be political pressures involved in implementing the swaps, as SOEs will still need approval from the government. Meanwhile, as banks do not take direct stakes in these debt-for-equity
swaps, they do not need to raise extra capital to meet the capital reserve requirements. Instead, they will set up WMP subsidiary companies or invite third-party WMP firms to take stakes. Currently, all swaps are conducted at face value.

As at mid-March 2017 there were 24 publicly listed companies that had conducted or are looking to implement debt-for-equity swaps. Among those companies that have conducted the swaps programme, not many provide details about negotiating terms between the company and the bank. An exception is the swap implemented by Yunnan Tin Group (YTG), an SOE that has struggled amid the slump in commodity prices. From the detailed terms, it suggests that the swap programme might be deviating from the stated intention of deleveraging the corporate sector.

Listed companies involved in debt-for-equity swaps, March 2017

<table>
<thead>
<tr>
<th>Company</th>
<th>Sector</th>
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<tbody>
<tr>
<td>Sinosteel Anhui Tianyuan Technology</td>
<td>Chemicals</td>
</tr>
<tr>
<td>Sinosteel International</td>
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</tr>
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<td>Changshu Fengfan Power Equipment</td>
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<td>Zhongmin Energy</td>
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<td>Tianjin Printronic Circuit</td>
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<td>CFHI</td>
<td>Equipment manufacturing</td>
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<td>Qinchuan Machine Tool Group</td>
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<td>Yituo Group</td>
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<td>Hangzhou Advance Gearbox Group</td>
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<td>GI Technologies</td>
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<td>Shaanxi International Trust</td>
<td>Finance</td>
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<td>Finance</td>
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<tr>
<td>Dongxing Securities</td>
<td>Finance</td>
</tr>
<tr>
<td>Yunnan Tin Group</td>
<td>Metal mining</td>
</tr>
<tr>
<td>BBMG</td>
<td>Non-metal construction material production</td>
</tr>
<tr>
<td>Shandong Gold Group</td>
<td>Precious-metal mining</td>
</tr>
<tr>
<td>Cinda Real Estate</td>
<td>Real estate</td>
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<tr>
<td>Hainan Haide Industry</td>
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<td>Tempus</td>
<td>Tourism</td>
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<td>Zhejiang Orient Holdings</td>
<td>Trade</td>
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<td>TEDA</td>
<td>Trade</td>
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<tr>
<td>Fujian Mingdong Electric Power</td>
<td>Utility</td>
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<td>Chongqing Water</td>
<td>Utility</td>
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<tr>
<td>Sinotrans &amp; CSC Holdings</td>
<td>Water transport</td>
</tr>
</tbody>
</table>

Sources: WIND; The Economist Intelligence Unit.

In October 2016 YTG, China Construction Bank, CCB Trust and China Cinda Asset Management co-signed an agreement on a Rmb5bn debt-for-equity swap for the firm. The agreement was designed to lower YTG’s debt-to-asset ratio by 15 percentage points, representing a significant softening in the
China’s supply-side structural reforms: Progress and outlook

The firm reported debt of Rmb35bn and an almost 80% debt-to-asset ratio in 2015, far above the industry average of 55%.

Digging into the agreement, however, there were two important requirements that raise questions about its viability. First, the involved parties have established a pre-agreed dividend distribution requirement each year. This obliges YTG to pay out dividends regardless of its financial performance. Second, YTG will have to exercise the debt-for-equity swap repurchase agreement at book value if it does not meet a target of delivering revenue of no less than Rmb81bn and profit of no less than Rmb2.3bn in 2020. This is a hugely ambitious target: in 2013-15 YTG averaged a yearly loss of around Rmb2bn.

Under such arrangements, investors appear to be holding a bond rather than equity. A guaranteed yearly dividend is akin to a coupon payment and the repurchase agreement works as a final guaranteed principle payback. Thus, YTG—and companies implementing similar swaps—may be deleveraging on their balance sheets, but not in reality. Several years down the road, when the repurchase agreement triggers, YTG may again face the debt repayment problem it is currently facing.

There is one important difference, however. The creditors will not be the banks, but the holders of WMPs and the backers of trust funds. This means that while banks will not be exposed if the distressed company does not meet its targets, households investing in WMPs and trust funds may have to take a haircut. As noted above, the targets embodied in YTG’s debt-for-equity swap are hugely challenging, especially when considering SOE management inefficiency and the lack of influence new equity holders are likely to hold over the company’s decision-making.

**Shifting the burden to households**

Although the focus within SSSR on the corporate deleveraging is welcome, the programme set out to date probably amounts to less than what is required. At best, debt-for-equity swaps may buy some time for struggling companies, but if that time is not used to drive reforms and productivity gains, it will have only delayed the debt reckoning. The modest scope of SOE reforms does not provide much encouragement on this front.

The other risk, highlighted by the structuring of the debt-for-equity swap programme, is that the authorities look to shift the burden for corporate debt repayment to the household sector.

Household sector debt stood at the equivalent of 43.2% of GDP at end-September 2016, according to the BIS, a healthy level compared with the global average of 58.1%. However, given that rising house prices are requiring larger mortgages, household sector debt is increasing rapidly—it rose by 5 percentage points alone in the 12 months to end-September 2016.

As such, leaning on households to resolve soured corporate debt problems is no longer the option it was in the past. In the early 2000s households picked up the bill when the banks ran into troubles with corporate NPLs. Public money was used to bail out some lenders, while generous government-fixed interest-rate margins meant that banks were able subsequently to grow their profits comfortably, to the detriment of depositors. Yet with household consumption now serving as the main driver of GDP growth, and leverage in the sector already rising quickly, there is less room than in the past to shift the burden.
IV. Lowering corporate costs—China’s “Reaganomics”

Entrepreneurs have long complained about the challenging operating environment in China. There are far too many regulations—especially in terms of taxes and fees. Land rents, energy costs and labour costs have soared, eating into profit margins. The “lowering costs” objective included in the SSSR agenda is a response to those concerns. In terms of policy, this part of the SSSR is probably closest to the tax-cutting agenda associated with supply-side economics (or “Reaganomics”) in the US.

Cutting corporate costs is designed to support several policy goals. It may help to reduce the pace of industrial relocation from China to cheaper regions in Asia. Although the government is not adverse to the trend, given its focus on fostering high-value-added industry, it does not want it to proceed too rapidly. Incentive policies for businesses are also seen as helping to foster their early development and raise their competitiveness. Finally, a reduction in fees and associated red tape is meant to stimulate what the premier, Li Keqiang, has called “mass entrepreneurship”—implying a recognition that China cannot rely on SOEs to fuel its economy.

Less fees, but no major tax cuts

At present, the corporate income tax (CIT) rate is 25% for most businesses, but lower rates of 20% and 15% apply for micro- and small-sized enterprises and high-technology firms, respectively. This is lower than the standard rate of 35% in the US and the level in many developed European countries, but higher than Asian economies such as Japan, South Korea and Vietnam. Moreover, according to estimates by the World Bank, corporate tax as a percentage of corporate profits reached 68% in China in 2016, the 12th-highest ratio globally and roughly two-thirds more than the average level in high-income countries—suggesting that it is relatively burdensome.

As a result, there is increased discussion about reducing CIT. In official policy circles, there have been calls to cut the rate to 22%. However, this might be too radically pro-business given strong left-wing sentiment within parts of the CCP. Currently, plans to reform CIT are relatively minor. In 2017 the government is committed to raising the annual income threshold at which small companies begin paying CIT from Rmb300,000 to Rmb500,000.

The major tax reform to date under SSSR was the replacement in 2016 of business tax (BT) with a value-added tax (VAT). Although the VAT rates are higher than BT, deductions in input costs will in theory help firms to save money, allowing the government to characterise it as a form of fiscal stimulus. Yet it was also an effort to counter tax evasion. This is because under the VAT system companies need official receipts (known as fapiao) to obtain deductions. Companies will therefore enjoy a lower effective tax rate, but will also face pressure to declare more income. As such, the boost for firms might prove relatively short-lived. Reliable information on levels of tax evasion is not available, but academics have estimated that as much as 26% of personal and corporate taxable earnings might be lost to avoidance in China.
China’s supply-side structural reforms:
Progress and outlook

Probably more promising from a cost-reduction perspective will be steps to lower administrative charges and “government funds”. Such charges are collected by the government from companies to support local public services, such as education and urban maintenance. Land-transferring fees are another major item for firms to bear. By our calculations, government fees were equivalent to 10.5% of GDP in 2016, with the total revenue of CIT, VAT and BT (with the latter being phased out) accounting for only 10.9%. Nonetheless, efforts are ongoing to reduce charges: according to the Ministry of Finance, there were 106 administrative fees in 2016, down from 496 in 2013. The authorities plan to abolish one government fund charge (urban public services) and cut a further 35 administrative fees in 2017.

Regional incentives make a comeback

Government support for corporate bottom lines may also be forthcoming in the form of incentives and financing. Subsidies are a well-established feature of industrial policy. The Made in China 2025 (MiC 2025) plan is the latest iteration of this approach, promising substantial support for firms in eight “strategic” industries, ranging from advanced equipment manufacturing, new-energy cars and energy-saving industries to information technology. They are set to benefit from favourable prices for land, energy and direct cash support.

Incentives may also return. These were scaled back in late 2014 when the State Council called for the “clean-up and standardisation” of regional incentives, depriving local administrations of some of their power to offer tax breaks and operational discounts to investors. However, concern about weak investment by domestic private and foreign firms is encouraging the government to rethink its approach. The government work report presented in March 2017 by the premier, Mr Li, reasserted the power of local governments to offer “preferential policies” to foreign investors.

There may be less room for government support in terms of financing costs for firms. With the strengthening in producer price inflation in late 2016, many industrial firms actually began to enjoy effective negative interest rates. Higher inflation and the need to dampen the housing market are likely to prevent any further cuts to the PBC’s benchmark rates.

There is still nevertheless much scope for reducing private firms’ borrowing rates. The one-year lending rate within the “Wenzhou Index”, a composite of private-sector lending rates compiled by the PBC, stood at 14% at end-January 2017. This compared with a prime one-year lending rate of only 4.35%. SOEs generally obtain credit at the prime lending rate or below.

Social security and environmental burdens

Another burden that the government aims to tackle is social security costs. The urban employee pension scheme requires a contribution of 28% of payroll, with employers providing 20% to a social pooling account and employees contributing 8% to individual accounts. At 28%, the contribution rate is significantly above Japan (15.4%), the US (12.4%) and South Korea (9%). A recent survey of corporate costs conducted by Li Shi of Beijing Normal University showed that social security’s share of total costs for manufacturing firms surged from 4.2% in 2005 to 7.9% in 2015—representing a bigger rise than labour wage growth.
Pilot programmes to lower the contribution made by employers to social security started in 19 provinces in 2017. The main constraint on major changes, however, is the frail financial health of the national pension scheme. At end-2015 over 90% of individual accounts were empty, with local governments using them to fund current pension expenditure. The situation is particularly grim in north-eastern provinces with aged populations and little migration inflow among the working-age demographic.

Environmental costs have also increased substantially for companies: they accounted for 6% of manufacturing firm costs in 2016, from almost zero in 2005, based on the survey data from Beijing Normal University. Such costs include pollutant discharge fees, required equipment purchases, waste treatment and carbon-emission certificates. An environmental tax is set to be imposed from the beginning of 2018, replacing the pollutant discharge fee. Although it does not tax carbon dioxide emissions, companies that directly emit pollutants are set to pay noise pollution fees of Rmb350-11,200 per month, based on their decibel level; Rmb1.2 per 950 g emission of sulphur dioxide; Rmb1.4 per kg of
Chemical oxygen demand; Rmb1.4 on water pollutants; and a range of Rmb5-1,000 for each tonne of solid waste. According to a study by Beijing’s Central University of Finance and Economics, the environmental tax is expected to generate Rmb50bn in revenue after its implementation, more than double current environment-related costs.

The scope for corporate cost reductions in the coming years is therefore mixed. Its inclusion in the SSSR agenda provides a signal of government intent, and policy discussions around the subject are intensifying. However, political considerations may prevent a radical, liberalising shake-up in the corporate tax code, while there are fiscal limitations to what can be done in terms of lowering the social security burden. The most likely focus for policy will be on reducing government fees, which will be welcome—if not game-changing—boost for corporate bottom lines.
V. Improving weak links—up the value chain

The emphasis on SSSR stems from a need to solve a pain for China’s economy—the mismatch between supply and demand. The Chinese economy has maintained rapid growth over past decades, but it still does not produce the full range of goods and services that are demanded by increasingly wealthy domestic consumers. China has more than enough supply of coal, steel and housing, but locals go abroad to acquire high-end consumer products ranging from Japanese toilet seats to baby nappies.

With China’s cost advantages slipping, the government is looking to upgrade industrial production capabilities so that they are better aligned with domestic demand. The “improving weak links” component of SSSR is aimed mainly at this objective, although it also incorporates a confusingly broad range of policy efforts, including poverty alleviation and infrastructure development. Running alongside the MiC 2025 agenda, it promises to accelerate growth by raising productivity and competitiveness through industrial restructuring, transformation and upgrading.

Innovation gains

Boosting domestic capabilities in innovation is at the forefront of these efforts. Officials are talking up innovation, promising that substantial resources will be dedicated to upgrading value chains, improving both software and hardware technology. Besides the MiC 2025 initiative, which focuses on delivering efficiencies in manufacturing, in 2015 a government programme named “Mass Entrepreneurship and Innovation” was launched. It aims to empower start-ups with preferential policies relating to initial public offerings, crowdfunding and administrative assistance. This includes provisions to allow the listing of internet and high-tech companies that are still unprofitable on the ChiNext, China’s equivalent of the NASDAQ stock exchange.
Innovation and entrepreneurship in China have taken steps forward and high-tech industry has developed rapidly over the past decade owing to an infusion of capital and foreign direct investment-embodied technology. Many producers across a variety of industries started out as contractors for original equipment manufacturers (OEM), producing components for foreign-brand products. Subsequently, some factories, mostly in the electronics industry, began transitioning from OEM to original design manufacturers, handling many aspects of design processes.

China is now home to an array of successful self-branded companies. Huawei (telecommunications), Lenovo (computing) and Haier (electronics and home appliances) have emerged as innovative companies with strengths in product development and process innovation. All are involved in a high level of technologically sophisticated designs. The same applies to the internet giants, Alibaba and Tencent.

Except for a handful of technology companies, however, China’s manufacturing industry in general is still stuck largely at the lower levels of the high-tech value chain and lag firms from developed countries in the development of core technologies. Although China is the world’s largest manufacturer of smartphones and personal computers, it still depends on other countries for high-performance circuits and core software.

**Made in China 2025**

In mid-2015 the central government launched MiC 2025 in an effort to help to close the innovation gap. It targets ten high-tech industries for development, and aims to lever technologies like the “Internet of Things”, cloud computing and big data to upgrade the country’s existing manufacturing industries. Specific targets are set out for 2025, including increasing the domestic market share of Chinese suppliers for basic core components and “important” basic materials to 70%; for mobile-phone chips to 70%; for industrial robots to 70%; and to renewable-energy vehicles to 80%.

There is a lot of catching up to do to meet the goals. In 2014-15 about 80% of the mobile-phone chips sold in China were imported. And in 2015 China’s market shares of domestically produced industrial robots and renewable-energy vehicles were just 27.4% and 1.35%, respectively.

To support the programme, significant government funding has been set aside. The Advanced Manufacturing Fund runs to Rmb20bn and the National Integrated Circuit Industry Investment Fund amounts to Rmb139bn. The former fund is managed by the State Development and Investment Corporation, while founders of the latter include China Development Bank, China Mobile and Shanghai Guosheng Assets, among others. In addition, the government is also encouraging large SOEs to establish, or take part in, venture investment funds to provide more funds for start-ups. According to data published by a consultancy, Zero2IPO, Chinese government-backed venture funds raised about Rmb1.5trn in 2015.

Integrating information technology with manufacturing is an important element in MiC 2025. Chinese factories lag far behind in industrial automation. Despite the fact that China is the fastest growing market for industrial robots, the degree of robotics in manufacturing, or automation in general, is still at a low level. According to Automation.com, an online source covering factory
automation, the proportion of machine tools with numerical control in China is about the same level of Japan in the late 1970s.

Associated with the drive to strengthen weak links and MiC 2025 has been an acceleration in international technology-seeking acquisitions by Chinese investors. Many Chinese enterprises have sought to tap engineering skills and manufacturing know-how in Western markets. According to data from Dealogic, a financial markets platform, China outbound M&A reached US$111bn in 2016, surpassing the US$107bn recorded in 2015, with the number of deals up by 79% to a record 300.

Chart. China’s top ten global M&A deals, 2016

<table>
<thead>
<tr>
<th>Month</th>
<th>Investor</th>
<th>Investment (US$ bn)</th>
<th>Transaction party</th>
<th>Sector</th>
<th>Country</th>
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</thead>
<tbody>
<tr>
<td>June</td>
<td>Tencent</td>
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<td>Supercell</td>
<td>Entertainment</td>
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<td>Lexmark</td>
<td>Technology</td>
<td>US</td>
</tr>
</tbody>
</table>

Sources: Dealogic; The Economist Intelligence Unit.

**Top-down limitations**

It is easy for the central government to talk about the development of industrial chains. But MiC 2025, as well as other initiatives under strengthening weak areas, will still have to prove whether they can be effective in practice. The main driver behind China’s industrial upgrading over past decades has been the central government’s top-down policy. But as noted, there is still a lag between technology importation and indigenous innovation given that the majority of Chinese manufacturing exports are still lower-end products involving basic processing and techniques, while imports in general are much more sophisticated.

Chinese manufacturers also need bottom-up initiatives and investments, as well as the removal of bureaucratic and institutional hurdles. Their products of innovation must be protected through a robust legal system, the Chinese population itself must learn how to innovate and the country’s financial system needs to be able to channel money to where it is needed most—innovative start-ups rather than debt-ridden SOEs. The reality, however, is that entry thresholds to certain monopolised sectors are prohibitively high, protection of intellectual property rights remains inadequate and the education system is not prepared to train the next generation of skilled, innovative workers.

Thus, more than top-down policies will be required for China successfully to change its development model in favour of innovation. The government will need to provide not only an accessible market that
will encourage competition, but also a robust regulatory and legal framework. Moreover, managerial culture and the professional level of employees will both be important if Chinese enterprises are to raise the output value of their products at each stage of the production process. Unfortunately, these points are less emphasised in SSSR than they ought to be.
Conclusion

Overall, the government can look back on the first year of SSSR with a degree of satisfaction. Progress was made in some challenging areas. Overcapacity was reduced in the steel and coal sectors. Unsold property inventory fell for the first time in several years. A rise in inflation helped to ease debt-servicing strains for firms. VAT reform was completed. The MiC 2025 programme was rolled out further under improving “weak links”.

Caveats ought to be applied. Headline excess capacity cuts were less impressive than they appear, as they included a significant portion of already-idle capacity. Property inventory fell, but only slightly, and there was little progress in coaxing buyers into third- and fourth-tier markets. The uptick in inflation might prove short term, while broader deleveraging plans—such as debt-for-equity swaps—do not convince. The boost to companies from the extension of VAT is somewhat illusory, while plans to reduce CIT did not move significantly forwards.

Overall, we believe that across the main policy areas of SSSR, most progress in 2016 was made in terms of cutting overcapacity, with the least occurring in the lowering-corporate-costs component of SSSR.

In the period to 2020, however, we expect progress across these areas to shift. We are relatively optimistic on the prospects for a reduction in corporate costs, which ought to be easily achievable via slashing government fees even without adjusting CIT. Moving the industrial economy up the value chain is a process well under way, and the financing available under MiC 2025 and the widening capabilities of domestic private-sector technology firms ought to help to sustain it.

We are less optimistic about the other components of SSSR. Overcapacity cuts will become much harder as they extend into areas of productive capacity, especially in the SOE sector, which will have a greater bearing on economic growth and the labour market. Restructuring funds set up by the government to help to facilitate the process are not substantive and are also being poorly deployed. Curbing credit supply to overcapacity sectors, alongside other aspects of the deleveraging programme, will help to slow the pace of debt accumulation. But we doubt that reforms in the SOE sector will be ambitious enough to help the sector to grow out of its debt.

We are least optimistic about prospects for destocking housing inventory. Curbing property supply will run contrary to the interests of local governments, especially given that a potentially revenue-offsetting property tax is unlikely to come into force before 2020. Concerns about the trajectory of the market will make investors and buyers wary of acquiring third- and fourth-tier assets, while reforms to the hukou system and land ownership are not proceeding fast enough to stimulate real demand among migrant workers.
Progress on implementing the main policies of SSSR
(1=fastest, 5=slowest)

<table>
<thead>
<tr>
<th>In 2016</th>
<th>By 2020</th>
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<tbody>
<tr>
<td>1. Cutting (industrial) overcapacity</td>
<td>Lowering corporate costs</td>
</tr>
<tr>
<td>2. Destocking (property inventory)</td>
<td>Improving “weak links”</td>
</tr>
<tr>
<td>3. (Corporate) deleveraging</td>
<td>Cutting (industrial) overcapacity</td>
</tr>
<tr>
<td>4. Improving “weak links”</td>
<td>(Corporate) deleveraging</td>
</tr>
<tr>
<td>5. Lowering corporate costs</td>
<td>Destocking (property inventory)</td>
</tr>
</tbody>
</table>

Source: The Economist Intelligence Unit

SSSR could achieve more if it was not a top-down, government-driven process. In contrast to classic supply-side economics, the initiative does not for the most part involve a smaller role for the state. The drive against overcapacity, for example, has been driven by government fiat rather than by economic logic. Deleveraging is being fashioned not through the broad-brush strokes of monetary policy, but via selective programmes shaped by the authorities. The MiC 2025 programme makes clear that the government will stay involved in picking industrial winners and losers.

Rather than supporting the market-friendly reform agenda set out in 2013, SSSR in many respects runs contrary to it. This may reflect broader political and social changes in the intervening period. Yet the reluctance to let the market drive supply-side reform means that the programme rests too much on political will for its enforcement. At present, political support for the programme is strong, but SSSR could quickly fall apart were it to ebb.

Businesses and investors therefore ought to adopt a cautious approach in their assessment of SSSR. It should not be mistaken for China’s Reaganomics, nor should it be assumed to be the salve that will cure the Chinese economy of its ills.

Most importantly, SSSR provides a salutary lesson in the importance of monitoring and understanding government policy in a non-market economy. Many of the major economic developments in 2016, such as soaring coal and housing prices, were tied directly to the programme. It is set to be an important force shaping commodity prices, infrastructure investment, SOE profitability and property prices, among other areas, in the years to come. Grasping the dimensions of SSSR and the shifting scope of the policy should be a critical part of planning for any China-facing business.
Access China is a unique service that will help your business to succeed in China. It is the only single source of data, analysis and forecasts for all 31 provinces and 292 of China’s largest cities, providing you with a comprehensive understanding of China today, but more importantly giving you confidence that you will still understand China in ten and twenty years’ time.

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