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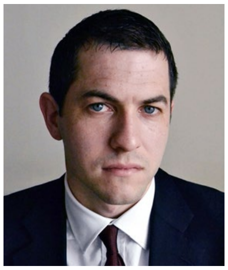
Bloomberg BRIEF

CHINA'S TRANSITION

THE THIRD PLENUM – ONE YEAR ON

In November 2013, China's leaders held a summit meeting — known as the Third Plenum — to hammer out a plan for putting the economy on a sustainable growth path. The *Decision on Some Major Issues Concerning Comprehensively Deepening Reform* provided a roadmap for change that would span economic, financial, social and environmental policy. One year on, Bloomberg Brief has invited leading experts to gauge progress, and the challenges that remain.

CONTRIBUTORS



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ALIGNING INCENTIVES

TOM ORLIK, BLOOMBERG ECONOMIST

A Vested Interest in China's Reforms

The challenge for China's reformers has never been what to do; it's always been how to do it in the face of fierce opposition from those with an interest in maintaining the status quo. In the year since the Third Plenum, shifting incentives for banks, state-owned enterprises and local government officials are opening a path to progress.

Interest rate liberalization is a critical component of the reform agenda. Under the current system, low government-set rates for deposits act as a tax on household savers and subsidize wasteful investment by companies. The main barrier to change is China's banks, which fear that market-set rates would shrink profit margins.

The rise of wealth management products and money market funds — offering savers higher market-set returns — has changed the equation. Banks face an exodus of funds and substantially higher volatility in the deposit base. That shifts banks' views on rate liberalization from a cost to be avoided to a necessary evil if they want to compete on equal terms for depositors' funds.

Something similar is going on with reform of China's state-owned enterprises. Low performing SOEs are a drag on growth. Managers at these firms, fearing an end to their cozy tenure and fat expense accounts, are a barrier to change. A shift in the way compensation is calculated might change the way they think about the problem.

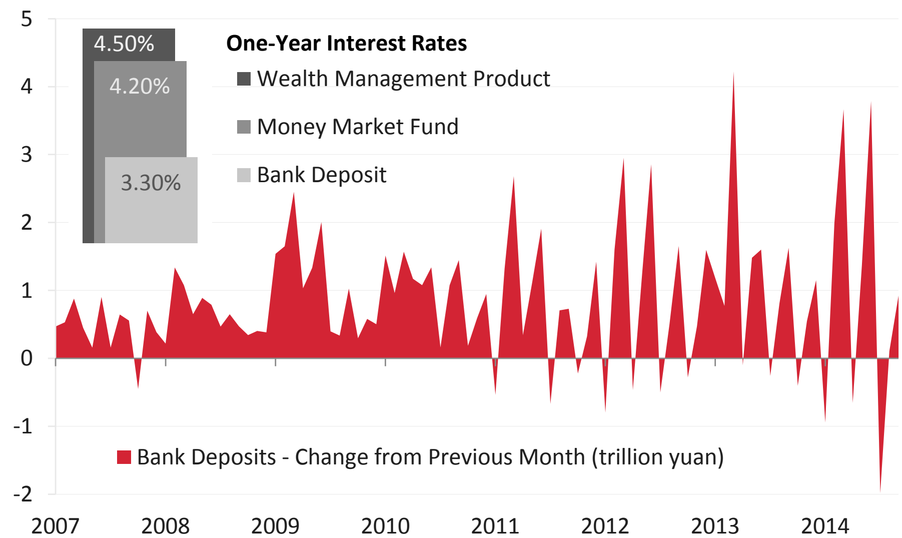
In August this year, the Politburo agreed to reform SOE executives' pay. Reports in the Chinese press suggest these change may include cuts of 70 percent for salaries that are already meager compared with international counterparts. At first sight, that appears little more than a populist measure aimed at appeasing public opinion on income inequality. There's a larger context to consider, argues Barry Naughton, a scholar on China's economy at the University of California at San Diego.

SOE reform means dividing companies into those with a commercial orientation — targets for marketization — and those with a mainly public service function. The new rules mean draconian controls on pay for public service firms that stay under the state umbrella. That shifts incentives for pocket-book focused executives from opposing market reforms at their firm to embracing them.

A final example comes from reform of China's system of household registration. In the past, local governments were implacably opposed to expanding welfare coverage to migrant workers, fearing a rise in social tensions and an increased burden on the public purse. Now, a combination of slumping property sales and dwindling supply of low-skill workers has encouraged some cities to roll out the welcome mat.

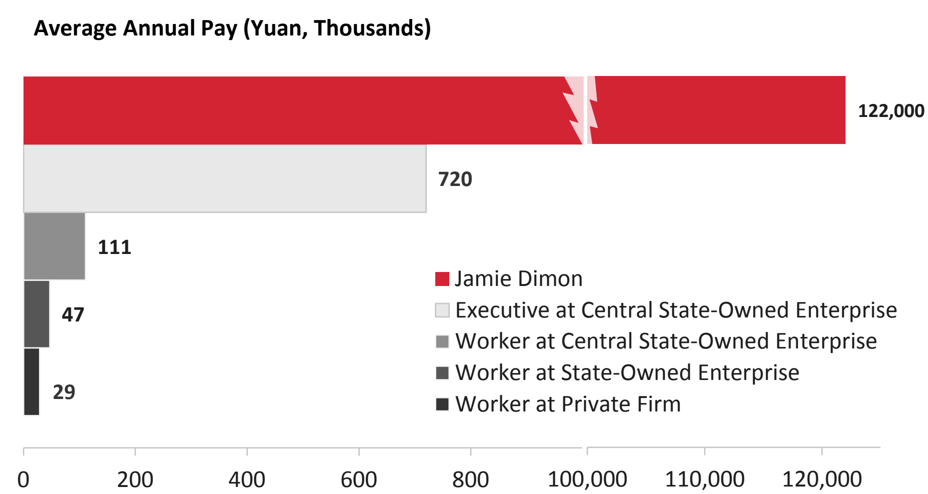
Executives at the big banks and SOEs, local government chiefs, and property barons have been the main stumbling block to reform. As incentives for these groups shift, the path to progress looks a little clearer.

Competition for Funds Drives Volatility in Bank Deposits



Source: Bloomberg BloombergBriefs.com

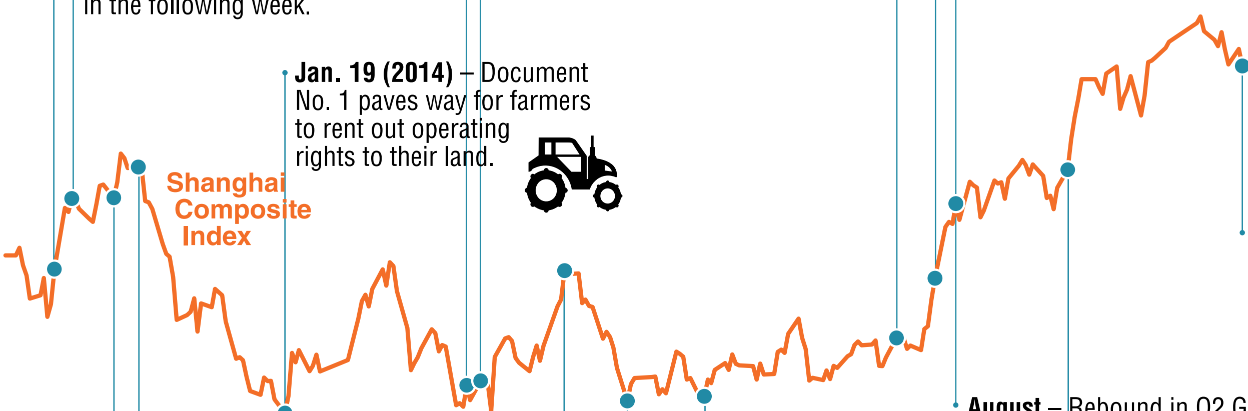
Compensation Caps Change Incentives for SOE Bosses



Source: China Leadership Monitor, Bloomberg BloombergBriefs.com

TIMELINE

JENNIFER BERNSTEIN, BLOOMBERG BRIEF EDITOR & TOM ORLIK, BLOOMBERG ECONOMIST



Nov. 15 (2013) – Relaxation of the one-child policy.

Nov. 20 – Markets welcome Third Plenum reform plan. Stocks rise 5.2 percent in the following week.

Dec. 2 – China Securities Regulatory Commission announces plans for reforming initial public offerings.

The People's Bank of China publishes regulations for Shanghai Free Trade Zone.

Dec. 7 – PBOC publishes rules for certificates of deposit — a step toward interest rate liberalization.

Jan. 19 (2014) – Document No. 1 paves way for farmers to rent out operating rights to their land.

March 8 – Chaori Solar becomes first default in China's bond markets, encouraging re-pricing of risk.

March 16 – PBOC widens yuan trading band to 2 percent either side of central parity from 1 percent.

National urbanization blueprint sets target of 100 million new urban hukou in next six years.

April 10 – China Securities Regulatory Commission announces pilot scheme to connect Hong Kong and Shanghai market.

April 17 – The Ministry of Finance raises state-owned enterprise dividend payout by 5 percentage points.

May 21 – MOF expands municipal bond pilot.

National Development and Reform Commission invites bids from private firms for 80 mega-projects.

July 15 – State-Owned Assets Supervision and Administration Commission identifies six SOEs for trial reforms; local governments launch their own plans.

July 25 – CBRC awards licenses to three private banks, including Tencent.

July 29 – State media announce investigation into former Standing Committee member Zhou Yongkang.

July 30 – State Council memo opens door to migration to small cities, closes door to big cities.

August – Rebound in Q2 GDP growth and optimism about Hong Kong-Shanghai equity link spurs rally in mainland stocks.

Aug. 31 – National People's Congress approves amendment to Budget Law.

Oct. 20 – Fourth Plenum affirms leadership of party, promotes judicial independence.

November – Resource Tax on basis of value rather than volume, a more effective way of taxing pollution.

FINANCE

ZHANG MING, CHINESE ACADEMY OF SOCIAL SCIENCES

Capital Market Reform: Two Out of Three Ain't Bad

Liberalization of the financial sector is at the heart of the government's reform agenda. A year on from the Third Plenum, the market is playing a significantly greater role in setting interest and exchange rates, and private firms are poised to change the character of the banking sector. On the opening of the capital account, a complex international environment and growing domestic financial risks mean progress has been more limited.

It wasn't necessary to wait long after the end of the Third Plenum to see the government's commitment to financial reform. In March, the daily fluctuation band of the yuan against the dollar was widened to plus or minus 2 percent. The yuan depreciated about 3.5 percent against the dollar in the first half of 2014. That reflected the central bank's intervention in the foreign exchange market to curb the carry trade, liquidation of bets on yuan appreciation and deteriorating macro-economic data. With the current account surplus shrinking and short-term capital flows volatile, the yuan's one-way appreciation trend has already ended. Looking forward, the risk of capital outflows triggering significant yuan depreciation can't be ignored.

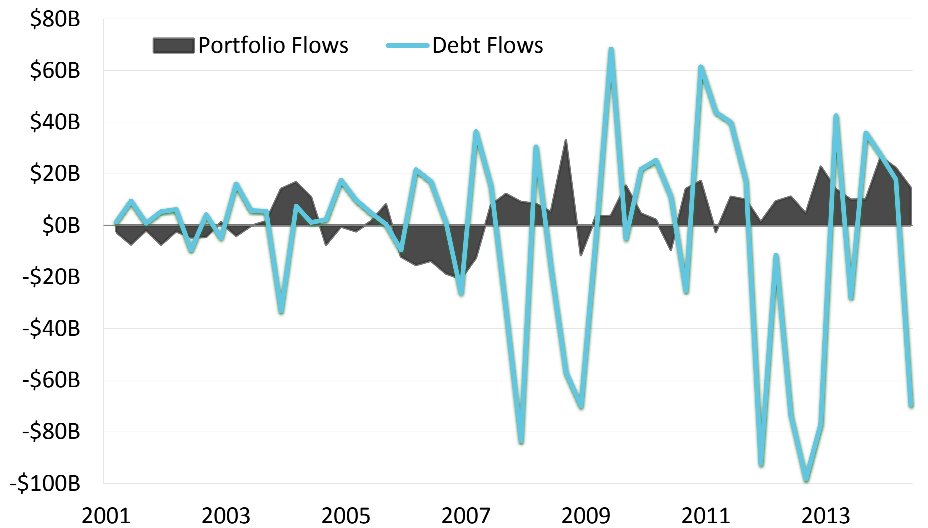
All interest rates except the benchmark deposit rate have already been liberalized. In 2014, commercial banks were encouraged to issue more medium-term certificates of deposit, with interest rates determined by market supply and demand. Wealth management products and money market funds continue to offer savers market rates for their funds — a type of back door interest rate liberalization. According to central bank Governor Zhou Xiaochuan, liberalization will be completed in the next one or two years. The national deposit insurance company, a prerequisite for market-set rates, could be established by the end of 2014 or early 2015. That would also pave the way for some small and medium-sized banks to fall into bankruptcy, without triggering widespread panic or runs on the remaining banks.

Several private companies have received licenses to start operating banks, including internet giants Alibaba and Tencent. In the short term, private banks will not have the scale to compete directly with state-owned banks. Looking longer term though, firms like Alibaba, which already work with millions of small businesses on their Taobao e-commerce platform, could plug the gaps left by the state banks, which tend to focus on loans to major industrial projects. Both interest rate liberalization and the creation of private banks introduce new risks. In other countries, including the U.S. and Japan, interest rate liberalization has triggered financial crises. That means stronger macro-prudential regulation — for example, ensuring banks have an adequate capital buffer — must accompany reforms.

Despite continued controls on the capital account, both the scale and the volatility of short-term fund flows have increased noticeably in the past several years. Yuan internationalization has opened new loopholes for funds to move across the border under the guise of trade settlement. The Shanghai Free Trade Zone and the coming tie up between the H share market in Hong Kong and A share market in Shanghai also create new openings for international capital flows.

Still, progress on capital account opening, including the development of the Shanghai Free Trade Zone, has been slower than expected. That reflects a tough balancing act for China's government between increasing efficiency by liberalizing cross border flows and avoiding the crisis that might follow from sudden capital outflows. The coming increase in interest rates in the U.S. as the Federal Reserve completes its exit from quantitative easing raises the chance of capital outflows from emerging markets, including China. Past excesses in China's lending make the problem more acute. Excess capacity in industry and real estate means the banks face a potential surge in non-performing loans, increasing their vulnerability to an exodus of funds. The fear of sudden outflows triggering yuan depreciation and a financial crisis rightly makes the People's Bank of China proceed with caution on capital account opening.

Volatile Flows Add Risk to Capital Account Opening



Source: Chinese Academy of Sciences BloombergBriefs.com

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FISCAL FRAMEWORK

LOUIS KUIJS, ROYAL BANK OF SCOTLAND

Budgeting for Reform

Public finance reform is a critical part of efforts to end local governments' debt binge and better match revenues with expenditure responsibilities. In theory, the agenda is clear and uncontroversial. In practice, shifting revenue channels and spending responsibilities inevitably runs into political difficulties.

Burgeoning local government debt — some 17.9 trillion yuan in mid-2013 according to the National Audit Office — is one of the main risks for China's economy. Part of the problem is lack of transparency. With no way to borrow on the books, local governments raised funds through a maze of financing vehicles that borrowed on their behalf. That made it hard for even the central government to track the rise in borrowing or monitor where the funds were going.

In the year since the Third Plenum, a new framework for local government borrowing was created. In August, the National People's Congress passed amendments to the budget law, allowing local governments to use the bond market to raise debt for public investment projects, subject to a central government quota. Lawmakers also changed the rules to give fiscal policy a more medium-term focus, make the budgeting system more comprehensive and transparent and consolidate government finances.

In late September, this was followed by State Council guidelines on managing local government debt, clearly delineating the purposes for which town halls can and cannot borrow. For public work projects with little or no commercial return, local governments can now issue bonds. Commercially-oriented projects would be financed through the market, separated fully from local governments' budgets.

The framework also clarifies the responsibility for the stock of existing debt. Only debt borrowed or payable by local governments and agencies would be categorized as local government debt. Debt borrowed by enterprises for which local governments are not liable will be paid according to market rules. This may involve write downs, although local governments will probably honor earlier commitments as guarantor. Local governments may apply to swap existing debt for bond issuance, in order to reduce interest costs and extend maturities.

The State Council also declared that the central government will not bail out local governments; local officials will be held accountable for transgressions in their performance evaluation and all local debt should be managed and disclosed as part of budget management.

It will take time for the framework to be up and running. Execution risks, such as a sudden halt in financing for certain projects, need to be managed carefully. It also remains to be seen if local officials toe the line. Nonetheless, by providing clear rules regarding local debt issuance and repayment responsibility and opening the door to a greater role for bond financing, the new framework is a step in the right direction. In time it should help move local governments toward harder budget constraints, lower borrowing costs, and more sustainable finances.

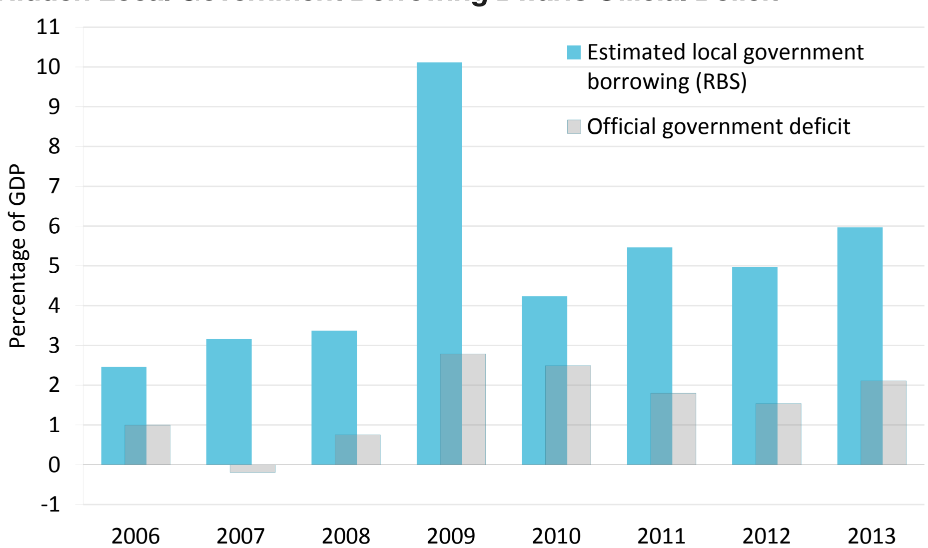
The second reform area — ensuring that local governments have the resources and incentives to provide education, health care and social insurance to migrants — is critical to improving the quality of urbanization by encouraging rural migrants to put down permanent roots in the city. So far, little progress has been made. That reflects the political difficulty inherent in reforms that impact local and national budgets.

One way forward is to raise the local tax base. Aligning local government interests in stronger tax revenue with central government interest in promoting vibrant household consumption, a thriving service sector and long-term settlement in the cities for rural migrants makes a lot of sense. A substantial property tax, which creates disincentives for investors to hold empty apartments and encourages local governments to swell their population, would tick the most important boxes.

A second possible approach is to recentralize expenditure responsibilities, either by more rules-based transfers from the central government or by moving responsibility for more spending items to the central government. That's what the government did nine years ago when it centralized responsibility for education. Recentralizing expenditure responsibilities would also help lower the very large gaps in access to public services between rich and poor areas.

Louis Kuijs is the chief China economist at Royal Bank of Scotland in Hong Kong.

Hidden Local Government Borrowing Dwarfs Official Deficit



Source: RBS

BloombergBriefs.com

STATE-OWNED ENTERPRISES

TOM ORLIK, BLOOMBERG ECONOMIST

Private Sector Advances, State Sector Retreats

Reform of China's creaking state-owned enterprises is a crucial building block of the government's agenda. **Nick Lardy,** Peterson Institute economist and author of 'Markets Over Mao: The Rise of Private Business in China,' discusses his views on progress in the last year, with Bloomberg's Tom Orlik.

Q: The conventional view is that SOEs dominate China's economy. How does your analysis lead to a different conclusion?

A: State firms dominate only in areas where entry by private and foreign firms has been restricted — upstream oil and gas, transport, financial services and telecommunications. In manufacturing, which has been open to private and foreign firms, state firms account for only one-fifth of output and one-10th of investment.

Q: The Third Plenum promised market reforms for interest rates. What's the impact of that on SOEs?

A: Phasing out the caps on deposit rates will raise banks' cost of funds. Banks will raise lending rates. This is likely to increase the flow of loans to private firms which have much higher return on assets and thus are more creditworthy.

Q: How about reform of energy prices? What will that do to state firms in the industrial sector?

A: The reform of energy prices, which is already underway, will reduce and hopefully eliminate the subsidy that has gone to industrial firms which consume most energy. This will lead to more investment and growth of services, which are much less energy intensive.

Q: The Third Plenum also promised to open state-dominated sectors to more competition. What progress has there been?

A: Progress to date is encouraging. Private airlines are getting more traction against incumbent state-owned airlines and some big SOEs, such as PetroChina have been forced to sell stakes in some business lines to private players.

Similarly private firms are getting licenses to import oil for the first time and private firms are making inroads in the gas business, in part because state companies are now required to lease long distance pipeline capacity to these private firms.

Q: How about ownership reforms? Is China moving toward a Singapore-type model for SOE ownership?

A: There has been a lot of discussion of the Singapore model for SOEs, but I am skeptical that this can work in China. The Temasek model requires a truly independent, sophisticated, private equity approach which I don't think is possible in China under current circumstances.

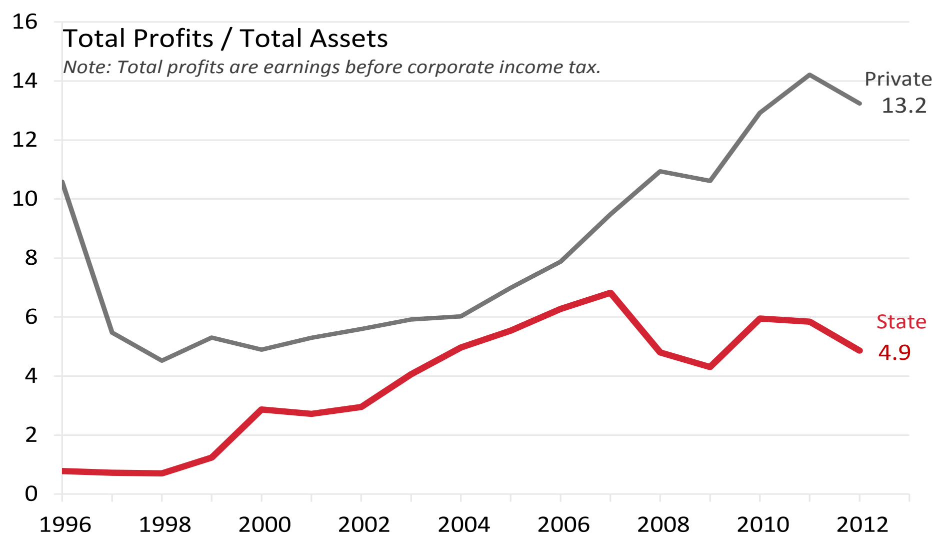
Q: What policy moves should we look for in the year ahead?

A: The key SOE reforms I am looking for are liberalization of entry in protected sectors, which would subject SOEs to greater competition, and a continuation of the trend of more bank lending to private firms, less to state firms. If SOEs can't improve their economic performance this should lead to further asset sales by SOEs.

Q: What's the prize for China's economy if they can get SOE reform right?

A: The prize is an increased possibility of sustaining rapid growth. State firms in both industry and services are very inefficient, as reflected in returns on assets that are half or even less than half of private firms. If private firms are able to enter currently restricted sectors the efficiency of use of capital will rise significantly, allowing China to moderate the growth of investment but still grow at around 7 percent to 8 percent.

Return on Assets for Private Firms Double SOEs



Source: National Bureau of Statistics BloombergBriefs.com

RULE OF LAW

CHENG LI, BROOKINGS INSTITUTION

Fourth Plenum Has Opened Up Discourse on Constitutionalism, Governance

A distinguished American writer, Sydney J. Harris, once said: "When I hear somebody sigh, 'Life is hard,' I am always tempted to ask, 'Compared to what?'" Perhaps the same can be said about the Chinese Communist Party's ongoing anti-corruption campaign. Party chief Xi Jinping has repeatedly said that rampant official corruption poses a life-and-death threat to the CCP and the nation.

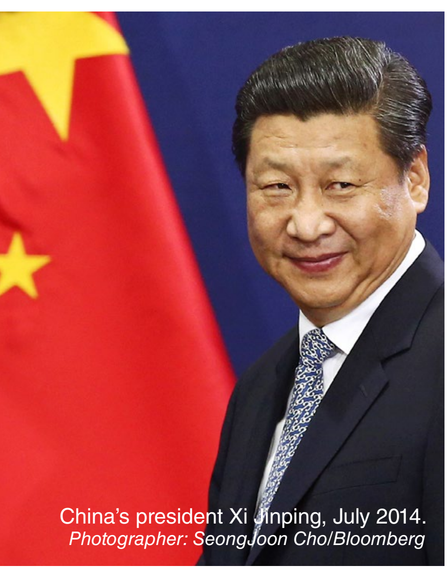
With the support of his principal political ally, anti-corruption czar Wang Qishan, Xi has launched a remarkably tough national anti-corruption campaign. In 2013, for example, the Central Commission for Discipline Inspection led by Wang handled 172,000 corruption cases and investigated 182,000 officials, the highest annual number of cases in 30 years. By October 2014, the Xi leadership had purged a total of 55 ministerial and provincial level leaders on corruption charges, including seven members of the newly-formed 18th Central Committee of the CCP and one member of the CCDI.

In an even bolder move, Xi recently purged two heavyweight leaders: former Politburo Standing Committee member Zhou Yongkang, who controlled China's security and law enforcement apparatus for 10 years, and former Vice Chairman of the Central Military Commission Xu Caihou, who was in charge of military personnel affairs for a decade. These moves greatly bolstered public confidence and support for Xi, contributing to his image as a strong, decisive leader.

Though this relentless anti-corruption campaign has already caused changes in official behavior, it risks alienating both officialdom — the very people on whom the system relies for effective functioning — and vested interest groups in monopoly-controlled business sectors. These main industries targeted by the campaign, including oil, utilities, telecommunication and banking, are also the pillar industries of state power.

Though his campaign has reduced official wrongdoing in the short term, the biggest risk for Xi is that his ad hoc anti-corruption effort may become a substitute for systematic legal and political reforms critical to bringing about a fundamental shift toward good governance in China. Because of the improvised character of his anti-corruption drive, various forces in the country — especially political rivals — will view Xi's anti-corruption campaign as primarily driven by factional politics and the need to consolidate power.

Xi and his team are apparently aware of these challenges. Wang said explicitly that while the ongoing anti-corruption campaign deals mainly with "symptoms, not the root-cause," it can help "gain the necessary time to find a way to cure the disease in the future." In a very timely move, the Xi leadership devoted the Fourth Plenum of the 18th Central Committee, held in late October, to the subject of rule of law and legal reforms. For the first time in CCP history, a central committee plenum focused on the country's legal development.



China's president Xi Jinping, July 2014.
Photographer: SeongJoon Cho/Bloomberg

Nonetheless, critics in China and abroad were disappointed with the resolution of the meeting because it did not stress the supremacy of the constitution over the CCP. Instead, it reaffirmed the party's leadership of constitutional reforms, implying that the party will remain above the constitution. Before the plenum, a quote attributed to Xi Zhongxun, Xi Jinping's father, circulated widely in Chinese social media. The story was that in the early 1990s the elder Xi, then vice chairman of the National People's Congress, said that China would always be at risk of disaster if the leadership did not figure out where the supreme power of the country should lie: the party or the constitution. Two decades later, this fundamental constitutional issue, as well as the risk of disaster, remains unchanged.

> *China would always be at risk of disaster if the leadership did not figure out where the supreme power of the country should lie: the party or the constitution.*

Despite the failure of the recent plenum to point to philosophical and ideological change in the CCP's governance of China, it outlines some important legal reforms. In particular, its establishment of circuit courts, which will operate across administrative regions, will bolster judicial independence. This change, along with development of a mechanism to keep records of officials who interfere in judicial cases, will ostensibly limit the party's influence in legal affairs. The plenum also highlights the imperative for professional training of lawmakers, judges and prosecutors and initiates a liability accounting system to hold officials accountable for poor decisions.

Critics' disappointment and the hesitation of CCP leadership aside, the Fourth Plenum has reopened much-needed public discourse on constitutionalism and governance in China. One can expect various forces in the country — from liberal intellectuals, human rights lawyers, and independently-minded legal professionals to Maoists, conservative party apparatchiks, and vested interest groups — in the coming years to contend on the legal front.

The next few years will be a test not only to see whether China's century-long movement for constitutionalism can find a more effective way to enlighten the nation at this critical time in history, but also a test for Xi. Will Xi make a lasting contribution by doing as he said he would, and "placing power in the cage of law"? If he does not, his fear — and the fear of his father — will not be calmed.

Cheng Li is director of the John L. Thornton China Center in the foreign policy program at the Brookings Institution in Washington and a director of the National Committee on U.S.-China Relations.

URBANIZATION

KAM WING CHAN, UNIVERSITY OF WASHINGTON

People Not Buildings — China's New Approach to Urbanization

China's creaking household registration system, known as the hukou, was a product of Mao's industrialization strategy. The system has been a barrier to full participation in the social and economic life of the city for hundreds of millions of migrants. During the past three decades, lack of reform has skewed China's urbanization path and produced a mammoth underclass, which threatens social stability. The case for reform has become overwhelming and the government has finally started to act.

Last December, the first ever national urbanization work meeting, chaired by President Xi Jinping and attended by the full Standing Committee of the Politburo, set the direction for reform. China's old approach to urbanization was all about construction of real estate and infrastructure. The work meeting signaled the start of a new type of urbanization — with the focus shifting to the social aspect.

In March, the long-awaited national urbanization blueprint for 2014-2020 set out specific objectives for the new approach. The government set a target of granting 100 million new local urban hukou in the next six years. This means extending coverage of urban social benefits, such as education and health services, to a group almost as large as the population of Mexico. That was a breakthrough.

The plan projects 60 percent of China's population will live in urban areas in 2020, up from 53 percent in 2012. The share with a local urban hukou will rise even faster, with the government targeting 45 percent in 2020, up from 35 percent in 2012. More than 99 percent of migrant children will receive free compulsory education, a significant jump from the current 60-to-70 percent level.

The government's target means extending coverage of urban social benefits to a group almost as large as the population of Mexico.

The reform program was confirmed and elaborated in a State Council memo released in late July. It provides the most comprehensive and detailed guideline for hukou reform and managing migration. Critically, the State Council distinguishes between the approach to migration in small, medium, and large cities. In small cities with populations under 500,000 migrants can settle freely, with all restrictions abolished. There will be some modest, still limited, opening of the door in larger cities, those with populations between 500,000 and 5 million. Stringent controls on migration and hukou conversion will be applied in cities of more than 5 million people.

After more than a decade of mostly empty talk, China's decision to address the hukou issue is a definite step forward. Even so, the differentiated approach between small and large cities is disappointing. The great majority of migrants live in large cities. The 2010 census reveals that 9 million and 7 million migrants lived in Shanghai and Beijing, respectively. Yet it is precisely in cities like these that migrants will face barriers in accessing social services and welfare. The scale of ambition is also limited. There is no timetable nor even a mention of an end to the hukou system, something many analysts have advocated in the last decade.

Implementation remains a major challenge and, as is well known in China, the devil is in the details. Without strong institutional support behind the central government's initiative it risks becoming just another blueprint, ignored or distorted by local governments. Charging a powerful commission to carry out implementation, as well as coordinating with reforms in rural land ownership, social security and the fiscal system, would signal the government's commitment to turn admirable objectives into real change on the ground.

Kam Wing Chan is a professor of geography at the University of Washington and a specialist on China's urbanization.

National Urbanization Plan: Selected Targets

ITEMS	2012	2020
Urbanization levels (%)		
De facto resident population	52.6	~ 60
Population with urban hukou	35.3	~ 45
Urban population without hukou	17.3	~15
Basic public services (% of coverage, based on de facto urban population)		
Migrant children receiving compulsory education	60-70*	≥ 99
Vocational training for new entrants to labor force	NA	≥ 95
Basic retirement insurance	66.9	≥ 90
Basic health care insurance	95	98
Social housing	12.5	≥ 23

Source: China's New Type Urbanization, March 2014

**Estimate by Author*

PROPERTY

HUANG YU, SOUFUN

Long-Term Adjustment Promotes Market Stability

The Third Plenum's plan for comprehensive reform did not directly touch on real estate, but it did address closely related areas in land, finance and tax. In 2014, the National People's Congress plan for adding 300 million new urban residents and an approach to real estate based on differentiation between cities and housing types had a direct impact on the sector.

In 2013, construction and prices in China's real estate sector reached new highs; sales for developers rose. The national picture masked clear differences between cities, but the overall trend was upward. In 2014, credit tightening and a change in market sentiment meant a reversal of fortunes. Transaction volumes have fallen, supply has continued to increase, and inventories have reached historic highs. In the first nine months of the year, sales area and value for residential property fell 10.3 percent year on year and 10.8 percent year on year respectively. The growth rate of new investment continued to fall, and new area under construction contracted. Some developers performed better than others. With pressure from high inventory and debt, enthusiasm for new investment fell and the land market cooled.

As revenue from land sales contracted, pressure on local government finances increased. That pushed 42 cities to relax controls on house purchases. This may have a short-term positive impact, but won't solve the problem of high inventory for developers. Local governments in Fujian, Hunan, Jiangxi and other provinces used housing provident funds, looser credit controls and tax policy to stabilize market expectations. At the end of September, the People's Bank of China lowered mortgage rates and down payment requirements for second home buyers and boosted financial support for social housing projects and real estate developers.

The new policy did the job. Market expectations improved, pent-up demand was released and more buyers came into the market. A number of indicators suggest momentum has been restored. Prices at newly launched projects are stable. The ratio of offers to sales is up. Transactions in the second-hand market are up 20 percent from before the September policy change. The biggest impact is on second-tier cities. In first-tier cities like Beijing and Shanghai, where controls on who can buy a home remain in place, and third tier cities, where inventory is high, the impact of the policy change is limited.

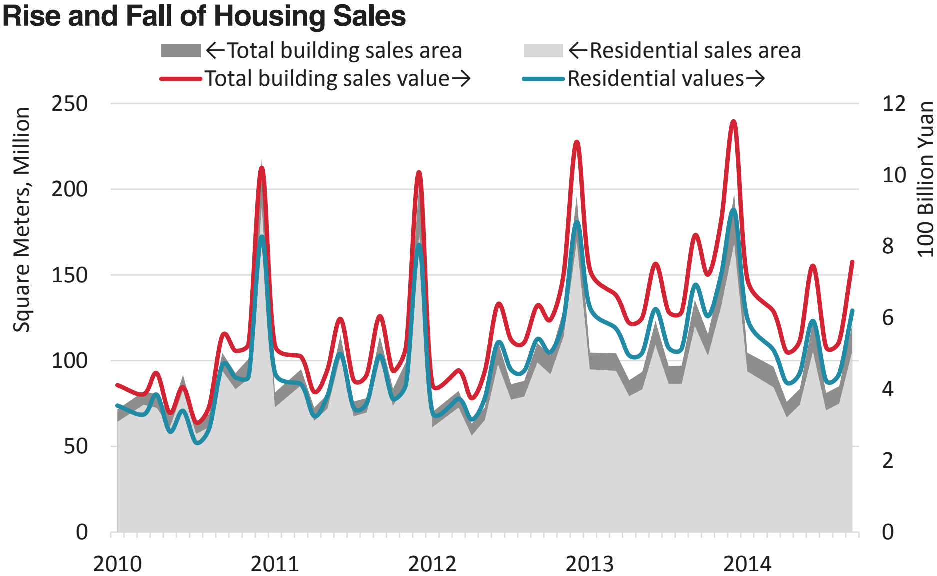
From a medium- and long-term perspective, many analysts have become more pessimistic about China property with concerns that overall supply exceeds demand. My view is there are still many factors that support the stable development of the sector. Economic growth remains stable at a relatively rapid pace and that will be a driver of continued investment and construction in the real estate sector. China is still at the middle stage of urbanization, with the urbanization rate just over 50 percent. There are plans for another 300 million urban residents. That breaks down as 100 million new urban migrants, renovation for 100 million residents living in sub-standard housing, as well as the urbanization for 100 million in central and western cities. That will be a long-term driver of real estate demand. A stable macro-economy will also allow the central bank to maintain a prudent monetary stance.

After many rounds of policy control and adjustment, China has started to establish a long-term mechanism for managing the sector. That will allow the gradual removal of short-term controls. The government will continue construction of affordable housing, balancing out supply from private developers. The efficiency of urban land use is improving, and the government continues to push forward land reforms. Development of a system of asset registration is accelerating moves toward a law on property tax. Administrative fees on the sector are being reduced, and the tax system has become regularized.

Approaching the end of the year, China's real estate sector has adjusted down from a high base. Looking forward, there is still room for demand to grow. The government is focusing on long-term mechanisms rather than on short-term controls, with greater respect for the market. Developers and home buyers are becoming more experienced. The environment for the sector is becoming more stable. China's real estate will continue to grow, though at a more gradual pace than before, as it enters a period of mature development.

Huang Yu is the Executive Vice Dean of China Index Academy, Director of China Real Estate TOP10 Research Group and Vice President of Soufun Group.

Rise and Fall of Housing Sales



Source: National Bureau of Statistics

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LAND

LI PING, LANDESA

Speeding the Plough on China's Land Reforms

Weak property rights for China's hundreds of millions of farmers and low compensation when land is expropriated are main sources of social unrest. By contributing to rural poverty and fueling a helter-skelter boom in construction, this situation is also a barrier to sustaining economic growth. The Third Plenum promised to address these problems, setting the market as the decisive factor for the allocation of land and strengthening farmers' property rights.

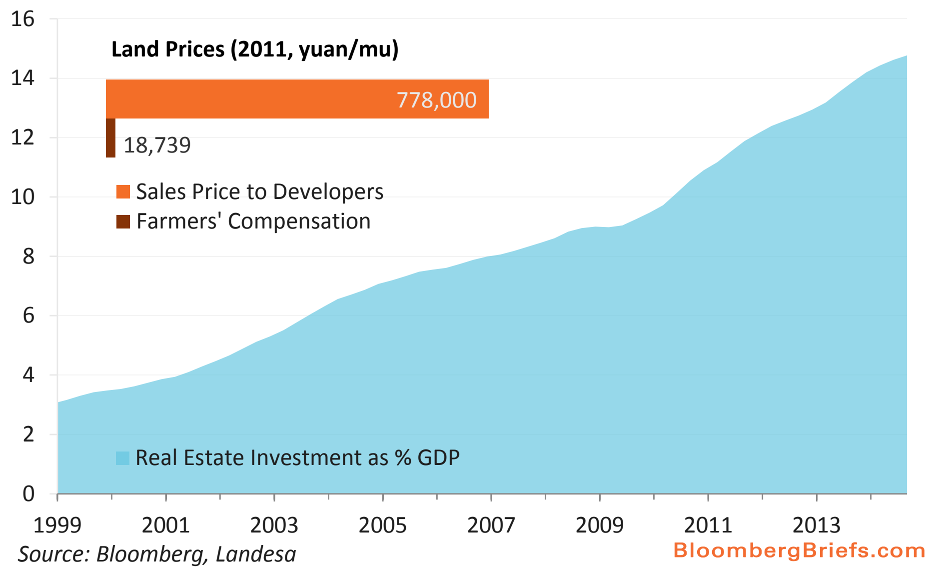
During the past year, China has made great strides toward increasing the marketability of agricultural land rights. Immediately after the plenum, the Central Committee and the State Council issued Document No. 1 of 2014, formally splitting farmers' agricultural land rights into contracting and operating rights. The distinction is contracting rights are not for sale while operating rights may be rented or mortgaged. That allows farmers to keep the title of their contracted land while generating higher income by renting out the use rights, mortgaging it for loans or converting it into shares in a farming entity in exchange for an annual dividend.

Making the new system operational will take work. To ensure security of farmers' rights and facilitate development of the operating rights market, China will launch a nationwide campaign for registering and certifying farmers' land rights. The aim is to establish a unified land registration system within five years.

Marketization of rights to farmers' non-agricultural land, called "rural construction land rights" in the Chinese terminology, has proceeded more cautiously. Despite the plenum's call for establishing unified markets for urban and rural construction land rights, subsequent directives and statements by policy makers have repeatedly defined marketization of rural construction land rights as being limited to the land used for rural enterprises. This is critically important because it means farmers' residential land rights, often farming families' largest asset, are essentially not marketable; they remain dead capital.

That cautious approach reflects concern that if farmers were able to transfer or mortgage their residential plot, they could lose it to the bank or greedy developers. The specter of millions of landless farmers flooding into already crowded urban centers — resulting in the kind of slums seen in India or Latin America — has long been a concern for China's leaders. While such concerns are understandable, further reforms are necessary for Chinese farmers to capture the full potential value of their most valuable and powerful asset.

Land Grabs Fueled China's Property Boom



Source: Bloomberg, Landesa

This last year has also seen remarkable progress in reforms of China's notorious land expropriation laws. The old system gave legal sanction to land grabs with scant compensation to the farmers. The new draft compensation laws repeal the cap on compensation — previously set at an unfair multiplier of the land's annual agricultural output. That paves the way to compensation based on the land's fair market value. As important, post-plenum reforms promise to allow farmers to share in the increases in property value that follow urbanization of rural land. Influenced by successful experiments in Taiwan, the forthcoming rural takings law will allow farmers to retain a certain percentage of the land to be expropriated and rezoned for much higher-valued urban development as a supplement to the statutory compensation and resettlement package.

Perhaps the most aggressive move in the past year is the central support for exploring ways to actualize member ownership of collective assets. China's Property Law defines rural land as owned by members of the collective. However, such member ownership remains essentially nominal because individual households have no functional claim to collective land ownership, nor to incomes from such ownership. The central leading group on reforms — headed by President Xi Jinping — recently adopted a pilot plan to reform collective asset structure into a shareholding structure and allocate shares to individual households within the village. Although it is premature to conclude the shareholding structure will make farmers into effective owners of collective assets including land, the plan clearly attempts to secure farmers' entitlement to incomes generated from collective assets in accordance with their shareholding status.

Li Ping is a specialist on China's land law and a senior attorney with Landesa.

ENVIRONMENT

ANTUNG ANTHONY LIU, CHEUNG KONG GRADUATE SCHOOL OF BUSINESS

Clearing the Smog on China's Anti-Pollution Strategy

Pollution has become a hot button issue in China. Concern about toxic factories has triggered protests in cities up and down the country. High visibility problems, like the smog that shrouded October's Beijing marathon, offer constant reminders of the progress that can still be made. Behind the scenes, though, the government continues to make smart plans and deliver small, incremental reforms.

At the Third Plenum, policy makers attempted to strike a balance between protecting the environment and shoring up the economy's development trajectory. If reforms agreed at the summit are implemented successfully, each could make a significant difference in improving environmental quality.

The leadership's first goal at the Third Plenum was to release officials in environmentally fragile areas from economic growth targets in their performance reviews. In the past, the local government incentive system — a powerful motivator for ambitious officials — set economic growth as the key criterion for judging performance. Once freed from these targets, officials may then focus their energies on ensuring the sustainability of their areas.

Its second goal was to work on land cleanup issues. An astonishing 16 percent of all Chinese land is heavily polluted, according to China's Ministry of Environmental Protection. Part of the reason for that is lack of clarity on property rights. The government is the official owner of all land in China and companies technically rent the land for extended periods of time. The result is uncertainty about who should pay for cleanup of polluted land or water.

It's cheaper to pick up and leave than to deal with the incredibly expensive task of remediating waste. That's what Shougang Group, China's fifth largest steel producer, did with an abandoned steel mill rusting outside of Beijing. While the site was shut down four years ago, the responsibility for cleaning the contaminated area is still under dispute. Unfortunately, property rights issues like this one are so complex that no legislation is expected until 2017 at the earliest.

The third goal was to monitor stress on natural resources and potential disasters. Releases of toxic chemicals have occurred with unfortunate frequency. One recent example was the 39 tons of carcinogenic aniline which leaked into the Zhouzhang River in Shanxi province in early 2013. The proposed monitoring and warning system is part of the draft "Law on the Prevention and Control of Air Pollution." This law has been drafted and circulated to receive public comments. If implementation is done right, it could be a useful tool to promote transparency on pollution incidents and to mitigate the negative impacts of environmental disasters on population centers.

Natural resource price reform is the fourth goal from last year's plenum. Market-based solutions like taxes force polluting companies to internalize the social cost of their actions while minimizing the damage to the economy.

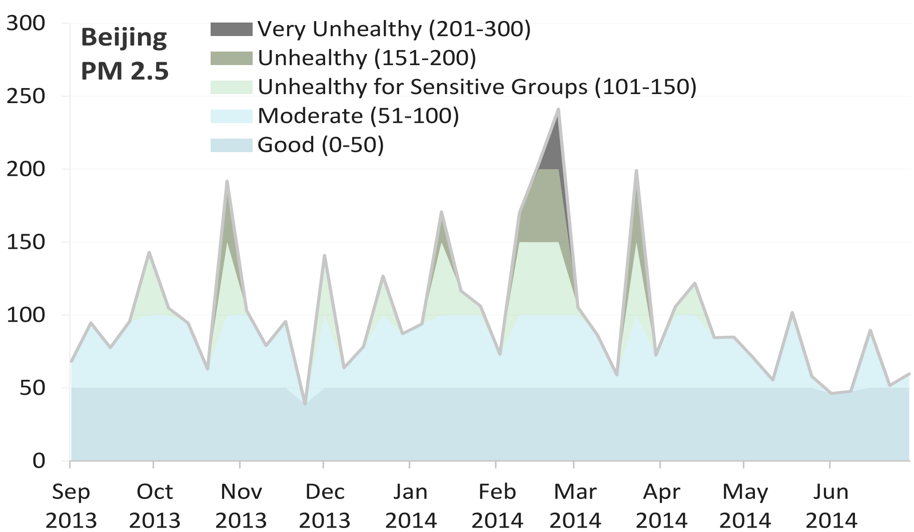
Starting Nov. 1, the resource tax will operate on the basis of value rather than quantity. As a result, the total tax paid for each resource is expected to rise significantly.

Moreover, for the first time the resource tax will cover important natural resources such as coking coal and rare earth metals. These are clear steps in the right direction. The resource extraction tax can act as a de facto pollution tax which will result in lower quantities of pollution. It has the additional benefit of being easy to monitor and collect.

Much remains to be done. Work on pervasive water pollution, addressing water scarcity through a smarter pricing system, and accelerating the shift away from coal, should all be priorities. That should not distract from what has already been achieved. China's leadership has made environmental quality a consistent high priority in its plans. Barring a significant economic setback, expect a continued drumbeat of small reforms and improvements in the coming months.

Antung Anthony Liu is a visiting assistant professor at the Cheung Kong Graduate School of Business and a fellow at Resources for the Future.

Waiting for a Breath of Fresh Air From Reforms



Source: Cheung Kong Graduate School of Business

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REBALANCING

Charting China's Year of Reform

BY FIELDING CHEN, BLOOMBERG ECONOMIST

Amid the pain of an economic slowdown there are hopeful signs that China's structural re-balancing is underway.

China's GDP growth dropped to 7.3 percent year on year in the third quarter, down from 7.5 percent in the second and the lowest reading since the first quarter of 2009. Bloomberg's Monthly GDP Estimate points to an even more pronounced slowdown, with a reading of 6.9 percent for the third quarter, down from 7.4 percent in the second.

Slower growth makes for bad headlines. That's only part of the picture. A slowdown that reflects attempts to tame runaway loan growth, deflate the property bubble and shut down redundant industrial capacity is actually good news for sustaining growth in the medium term.

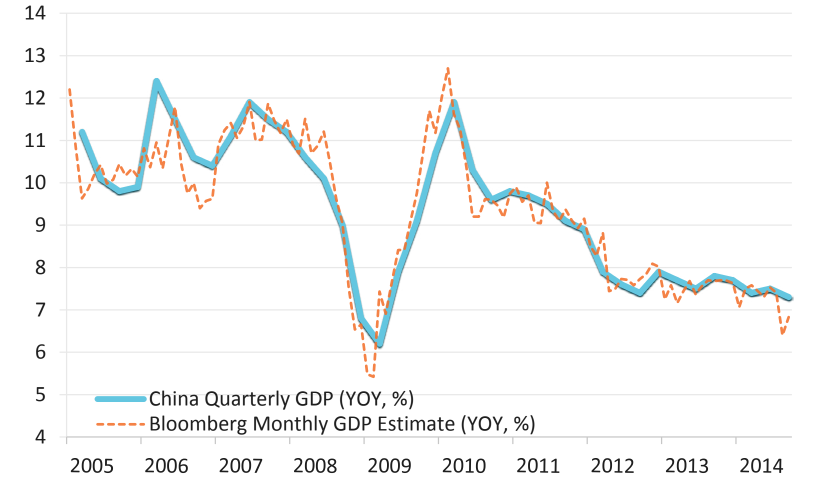
The People's Bank of China has so far refrained from large scale easing. Indeed, Bloomberg's Monetary Conditions Index shows that after a period of moderate stimulus in the second quarter the third quarter has seen the policy stance tighten, with higher real interest rates and a stronger yuan.

What stimulus efforts there have been attempt to kill two birds with one stone, supporting re-balancing as well as growth. The new approach to stimulus means targeting extra credit on small businesses and affordable housing projects, not state owned enterprises and luxury developers.

Bloomberg's Real Activity Indexes show that the government's attempts at reform are having an impact.

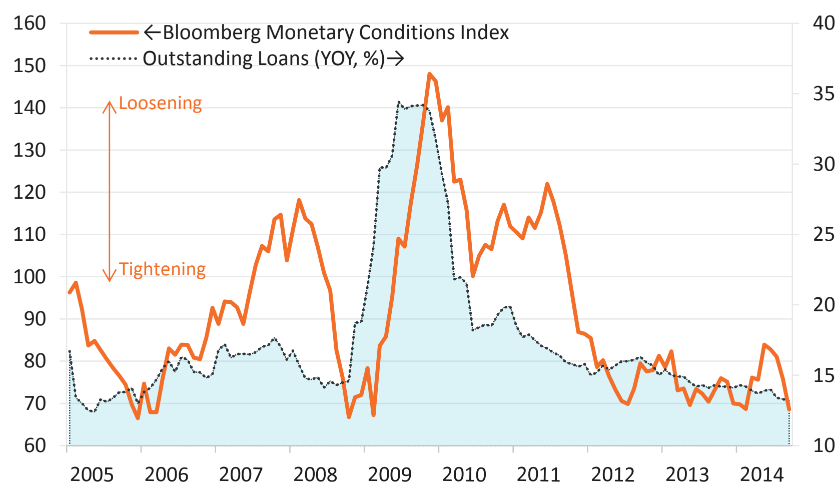
The "new" economy index — reflecting growth in consumption, advanced manufacturing, new energy, and the private sector — was up 12 percent year on year in September, up from 11.4 percent in August. The "old" economy index — reflecting growth in real estate, low-end manufacturing, thermal energy, and the state sector — declined to 5.9 percent from a previous 6.6 percent. Even as growth slows, China's old economy is being overtaken by the new.

China GDP Growth Decelerates



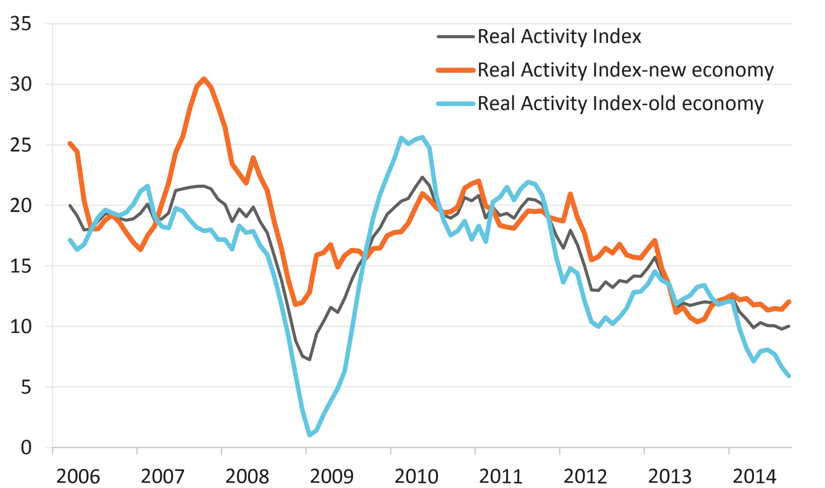
Source: Bloomberg BloombergBriefs.com

Monetary Conditions Tighten



Source: Bloomberg BloombergBriefs.com

New Economy Outpaces Old Economy



Source: Bloomberg BloombergBriefs.com

THIRD PLENUM OBJECTIVES

JENNIFER BERNSTEIN, BLOOMBERG BRIEF EDITOR & TOM ORLIK, BLOOMBERG ECONOMIST

	OBJECTIVE	PROGRESS	OBSTACLES	IMPACT
FINANCIAL MARKETS	A greater role for the markets in setting interest rates and exchange rates. A more diverse financial sector with a larger role for direct finance and greater access for private sector firms.	✓ Exchange rate trading band widened to 2 percent from 1 percent. ✓ Licenses for three private banks, including for internet giant Tencent. ✓ Revamped IPO process and plans for link up between Hong Kong and Shanghai equity markets.	Concern about stress in the banking sector has delayed progress on interest rate liberalization and capital account opening	More efficient capital markets will provide more growth bang for less credit buck.
FISCAL POLICY	A fiscal system that aligns taxing and spending responsibilities for central and local government, providing funds to pay for needed expansion of social safety net.	✓ Guidelines on responsibility for local government debt and expanded scope for local governments to borrow through official channels. ✓ Amendments to the budget law to improve transparency and consolidate the public finances.	Lack of progress on aligning tax and spending responsibilities means local governments have limited funds to pay for expanded coverage of health, education and pensions.	More far-reaching reform would reduce risks in the financial system from the overhang of local government debt and underpin medium term growth by paying for progress on other policy priorities.
SOE	Ratchet up private ownership, opening state sectors to greater competition, and raising SOEs' dividend payments.	✓ Pilot reforms for ownership of central and local SOEs. ✓ Dividend payments have been raised 5 percentage points.	Lack of clarity on which sectors are preserve of the state and which are open to competition.	Allowing greater scope to the private sector should allow the economy to sustain higher growth with less reliance on capital spending.
RULE OF LAW	Draw a line under rampant corruption and provide a firm basis for development by providing legal certainty for businesses and investors.	✓ Former Standing Committee member Zhou Yongkang has become the biggest tiger snared by the anti-corruption crackdown. ✓ The Fourth Plenum promised to boost judicial independence from local politicians.	Lack of institutional means to combat corruption and concern that the crackdown is as much about consolidating power as it is about improving governance. Concern that government treatment of foreign and domestic firms is not even handed.	A corruption crackdown that has snared senior figures in state owned enterprises, local government, and real estate developers could clear away opposition from vested interests to wider reforms.
SOCIAL POLICY	Expand welfare coverage to China's 100 million-plus migrant workers to enable them to make a permanent home in the city.	✓ Commitment to expand local urban hukou population by 100 million by 2020.	Plan blocks migration to major cities – where the economic opportunities are greatest. Lack of funds to pay for ambitious and expensive expansion of health, education and other services.	Expanding labor force participation should offset shrinking working age population. Allowing migrants to stay in the cities should underpin demand for low-end property.
LAND	Strengthen farmers' property rights, turning land into an asset that can be used to finance urban migration or improved productivity.	✓ Commitment to allow farmers to rent or mortgage their agricultural land. ✓ Higher compensation for farmers that have their land expropriated.	Lack of progress on allowing farmers to marketize their non-agricultural land.	Land reform underpins the government's urbanization strategy, supporting property demand and the transition to consumer-driven growth.
ENVIRONMENT	Address rising concerns about toxic levels of pollution.	✓ An expanded resource tax provides a market-based approach to addressing the problem of pollution.	Measures to shift incentives for local officials away from growth at all costs, and clarify responsibility for cleaning up polluted land remain work in progress.	Less resource-intensive growth will be more sustainable and improve quality of life for Chinese citizens.