

CAMRI ROUNDTABLE DISCUSSION: MEETING SUMMARY **The Third Party Plenum of the 18th National Congress**

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(This is a meeting summary of the CAMRI Roundtable Discussion led by Professor Anthony Neoh, QC, SC, JP, Member and the former Chief Advisor of the International Advisory Board of the China Securities Regulatory Commission (CSRC), the former Chairman of the Hong Kong Securities and Futures Commission (SFC), and the Dean's Visiting Professor at NUS Business School.)

The 3rd Party Plenum of the 18th National Congress of the Communist Party of China (CPC) last November marked the beginning of a new round of reforms in China and was taken as a milestone for China's reforms. The report released after the Plenum provided a set of important principles impacting the economy and society. What is the direction of the reforms? What policy changes may arise from the Plenum?

1. Review of the Third Plenums of the past 35 years

The importance of Third Plenums of the National Congress of the CPC lies in their focus on reform issues, as the first two preceding plenums serve to facilitate the smooth transmission of political power from the old to new generation of leaders. Following their election in the first plenum, the new leaders are thus allowed some time to amass public confidence and trust before presenting their important policy considerations, including economic reforms, in the Third Plenum.

In the eight Third Plenums of the past 35 years, two have been the most significant in China's reform process. The first is the Third Plenum of the 11th Central Committee in 1978, which marked the beginning of China's reform and opening up. The second is the Third Plenum of 18th Central Committee this past November, which was taken by public as the starting point for the new comprehensive and profound reform. Other important Third Plenums include the Third Plenum of the 15th Central Committee in 1998, in which private

property was respected, and the Third Plenum of the 16th Central Committee in 2003 where the private sector was recognized as a part of the economy.

Table 1: Third Plenums in the past 35 years

Year	Name of the CPC Congress	Theme
1978	The Third Plenum of the 11th Central Committee	Beginning of China's reform and opening up
1984	The Third Plenum of the 12th Central Committee	To shift reform from the rural area to urban area
1988	The Third Plenum of the 13th Central Committee	Price and wage reform
1993	The Third Plenum of the 14th Central Committee	Plan for socialist market system reform
1998	The Third Plenum of the 15th Central Committee	To build a socialist new countryside
2003	The Third Plenum of the 16th Central Committee	Scientific concept of development
2008	The Third Plenum of the 17th Central Committee	Further rural reform
2013	The Third Plenum of the 18th Central Committee	Comprehensive and profound reform

2. Four Principles related to Corporate Governance and Financial Markets

- I. The Market to Play a Decisive Role. The Plenary Session pointed out that reform of the economic structure is the focus of a comprehensive and deepening program of reform, the core issue of which lies in appropriate handling of the relationship between the government and the market, allowing the market to play **a decisive role** in the allocation of resources and enhancing the role of government. This is the first time the word “decisive” has been used to describe the role of the market and is the most significant change of the Third Plenum.

- II. Improve the Financial System and Market Mechanisms. The Plenary session pointed out that building a unified, open, competitive and orderly market system is fundamental to making the market play a decisive role in the effective allocation of resources. It must accelerate the formation of a modern market system which allows independent management, fair competition, freedom of choice in consumption, and the free movement and fair exchange of goods and means of production. In addition, efforts must be made to clear market barriers and enhance both the efficiency of resource allocation as well as the equitable distribution of resources. The Plenary session needs to establish a fair, open and transparent market rules, improve market price mechanisms to enable markets to be the principal determinants of price, establish a unified urban and rural construction land market, improve the financial markets system, and deepen the science and technology system.

- III. Accept Globalization and Relax Investment Access. The Plenary session stated that (we) must adapt to the new situation of economic globalization and promote mutual cooperation between domestic and international forces to accelerate further opening, so that whatever that has entered or exited may be better integrated into the economy. Furthermore, the free flow of important international and domestic factors must be facilitated so that the allocation of resources may be efficiently effected and markets may be deepened and further integrated. Finally renewed efforts may be made for the adoption of leading edge international cooperative practices thereby bringing competitiveness to a new level so that reforms may further progress. (We must) relax investment access,

speed up the establishment of free trade zones, and expand the opening of our inland borders.

- IV. Embed the Rule of Law. The Plenary session pointed out that in order to further embed the rule of law, they must deepen judicial reform, accelerate the construction of a fair, efficient and authoritative socialist judicial system and maintain and protect people's rights. Upholding the legal authority of the Constitution, reform should be deepened to build an effective system of administrative law enforcement, a judicial system capable of independently and impartially adjudicating cases and exercising pro-curatorial powers, a system for effective deployment of judicial power, and an improved system of judicial protection of human rights.

3. Potential Outcomes for China's Economy

There are several changes with respect to China's economy that could be expected after the Third Plenum:

- I. Liberalization of the markets. The government will start a deregulation process at the central government level as well as at local government level.
- II. Building of further financial infrastructure.
- III. Consolidation of regulation. The financing does not only rely solely on banks, but more on capital markets. The shadow banking issue can well be controlled and resolved.
- IV. Building a system of government that is more responsive to the needs and aspirations of a growing and increasingly affluent, well-educated urban population. With the development of social media and internet people are able to access information with greater ease, and with an increasingly educated population, the government officials realize the necessity of becoming more transparent with the rule of law.

4. Issues faced by China's Economy

- I. Rebalancing of the Economy. China has very high GDP and fixed capital investment growth rates, with GDP growth highly reliant on fixed capital investment, both of which have been slowing. There are also other problems, such as disproportionate lending to SOEs for capital investment by banks, where 80% of bank loans are held by SOEs, and lack of access to capital faced by small and medium enterprises. Both these issues contribute to the high growth of the unregulated shadow banking sector, where loan interest rates are 7% - 8% and occasionally 10%, which is much higher than the rates available at government regulated banks. The present national savings rate remains high, but the government wishes to encourage spending to stimulate domestic consumption. This raises the question: "What type of consumption ought to be encouraged?" Potential target sectors should be the education and social services sectors; however, the severe corruption that exists in public social services would reduce the impact of additional consumption in the sector. As such, the government's present anti-corruption campaign is expected to further bolster economic reform.
- II. SOEs and market dominance, particularly in the following sectors: transport, ports, natural resources, energy, and telecommunications. Many industries are dominated by several SOEs, which have formed natural monopolies. SOEs have been associated with operating inefficiencies as well as structural and organizational problems, and China needs more competitors in these SOE-dominated sectors.
- III. Taxation. Two problems exist in taxation. The first issue is the complex taxation system which is divided between the provincial and state governments. Also, the taxes collected by the local government are eventually paid to the central government. The second problem is tax collection inefficiency, which is also a by-product of the overly complex taxation system. The government has stated that in the future, the tax collection process will become more transparent.

- IV. Widespread accounting fraud and law evasion. Financial statements are part of the required submissions in a company’s required annual registration with the Company Registration Office. However, a company might have sets of financial statements which are furnished accordingly to the government, banks, or for internal use. As a result, Chinese banks do not trust company financial statements, and usually require collateral to be posted.

- V. Regulatory gridlock is present, and at the same time there are gaps in regulation, particularly for the financial sector.

- VI. Low law enforcement efficiency. The local governments’ ability to make sudden changes to the rules and unequal treatment of different companies have created a difficult environment for businesses to operate.

- VII. Low level of confidence in legal protections afforded to citizens is the primary driver for the exodus of capital by affluent Chinese citizens. In last 10 years, US\$ 797 trillion in funds had flowed out of China.

Figure 1: GDP Growth Slowing



Figure 2: Rate of Fixed Capital Investment Now Slowing



SOURCE: WWW.TRADINGECONOMICS.COM | NATIONAL BUREAU OF STATISTICS OF CHINA

Figure 3: Increasing Affluent Population



SOURCE: WWW.TRADINGECONOMICS.COM | WORLD BANK

Figure 4: GDP per Capita on a PPP Basis



5. China’s Financial Systems Issues

The banking system alone takes up most of the burden of financing, where the total outstanding loans value in all regulated banks at the end of 2013 was RMB 77 trillion. Since GDP was estimated to be RMB 54 trillion, bank loans are equivalent to 143% of GDP. This does not take into account shadow banking, which is estimated to be another 40% of GDP. Despite this, the stock market capitalization is less than 50% of GDP. A greater range of financial instruments, such as bonds and derivative markets, are required for the development of the financial sector. In addition, a detailed gap analysis of the regulatory system is required, to ensure the reformed system is one which plugs current existing gaps. Finally, much better law enforcement capacity is also required for the effective functioning of the financial system.

6. Other Issues Discussed in the Meeting

- I. The Third Plenum of 11th Central Committee in 1978 was a half done deal as it did not solve all the problems faced by the economy. The Third Plenum of 18th Central Committee last November is a starting point for the comprehensive reform including political and social reforms. As long as the system has not run away from rules, the reform is not too late. The Chinese government has to implement these reforms.
- II. Issues regarding pollution, the environment, population and democracy were also discussed in the Third Plenum and mentioned in its published report.
- III. Territory dispute between China and Japan. The Chinese government has to respect the people's view on Japan and at the same time manage the national sentiment. Given the strong trade ties between both countries, the Chinese government wants to cool down the dispute, but at the same time they cannot appear to be weak in the eyes of the people.
- IV. The Confucian tradition continues to be entrenched in Chinese society. Although under Confucian principles leadership is not questioned, the Chinese leaders of today realize that with an increasingly well-educated population, they will have to share rights with the people and ensure a transparent government.