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The Third Plenary Session of the 18th **Communist Party of China Central Committee (**CPCCC) was held between November 9 and 12 in Beijing. "Reform" was confirmed as the key theme of the 4-day meeting and the agenda has key implications to various businesses. While key reform ideas and directions were highlighted and agreed by the country leaders in principle, details of the respective execution plans were not detailed. It was not surprising to us since the plenary session only lasted for 4 days and it would not be feasible to talk about every detail due to the significant breadth of the topics. On the contrary, given the complexity of different issues, it will take time before all the arrangements are introduced, and it will require consistent effort by the country leaders to negotiate with a wide-range of stakeholders before the key operational plans will be announced.

We hope to use this paper to cover what we see as the key implications from the 4-day meeting. The focus of this paper is put on messages from the 4-day session that would lead to direct impacts on various industries and the vast business community.

Some key messages:

- Headline economic growth to slow and no massive monetary or fiscal stimulus in sight, while economic environment will remain accommodative
- As the government will actively and agressively tackle overcapacity issues, smaller and inefficient players in industries with overcapacity issues will be hurt
- The move toward a more open-economy signals higher intention for the China to participate in trade talks, but the *spaghetti bowl* situation could hurt smaller companies
- Higher volatility in renminbi (RMB) expected while RMB will appreciate 4% in real terms against the USD for 2014, and companies could hedge against currency fluctuation by invoicing and settling the bills in RMB
- Higher environmental standards and less subsidies on resources could hurt energy intensive industries

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The Third Plenary Session of the 18th Communist Party of China Central Committee (CPCCC) and beyond

Part I: Introduction

The Third Plenary Session of the 18th CPCCC was held between November 9 and 12 in Beijing. Since they came to the office in March, leaders of the current Xi-Li regime have summoned their power and come up with a comprehensive reform agenda. While bits and pieces of the reform plans have been announced in recent months, the Chinese leaders used the plenary session as the platform to channel their ideology and roadmap of structural reforms. Among the others, a key objective of the meeting was to address on the importance of reform and to find out how the government's work would evolve around the direction.

In China, the third plenary sessions have traditionally been a key event as several important decisions were either proposed or announced in such meetings previously. For instance, the implementation of reform and opening up was decided during the 11th CPC Central Committee, while the endorsement of becoming a "socialist market economy" was given in the 14th CPC Central Committee in 1993.

The plenary session this year was led by party leaders including President Xi Jinping and Premier Li Keqiang and well-attended by more than 370 top-ranked officials, party members and senior management of state-owned enterprises (SOEs). Important directions of future development were announced in the traditionally important meeting, covering topics related to economic, cultural, social, environment, government, state defence, etc.

While it is not our intention to have an exhaustive coverage on every detail of the plenary session, we hope to use this paper to cover what we see as the key implications from the 4-day meeting. The focus of this paper is put on messages from the 4-day session that would lead to direct impacts on various industries and the vast business community.

Message	Potential impact on business	Relevant industries
Moderating economic growth	Medium-term headline economic growth will be less robust and less reliant on stimulus; potentially lead to weaker investor confidence	All industries
Actively tackling overcapacity issues	Speed-up ousting of outdated production capacity; cease of capacity expansion; higher environmental standard and reduced subsidies	All industries facing overcapacity situations, especially steel, cement, aluminum, shipbuilding and glassmaking
Establishment of the SHFTZ to engage the global economy	Less restrictive environment for foreign enterprises in certain sectors; larger companies to benefit if China to eventually participate in TPP and relevant trade talks, while smaller companies could be hurt by the spaghetti bowl situation	Service sectors to benefit; financial services, shipping, special tele-communication services, professional services, cultural services, and social services to see less restriction within SHFTZ
On-going RMB Internationalization	Higher volatility of the exchange rate; appreciation of the currency would add pressure to domestic and export busiensses	All industries
Environment-friendly policies on the way	Rising environmental standards for most and reducing subsidies on resources for energy-intensive industries (e.g. steel, aluminum, etc.)	Pollution treatment and alternative energy (e.g. natural gas) companies to see supportive policy environment; automotive energy to see mixed policy environment

Part II: Policy direction

Reform-minded leaders...

“Reform” was confirmed as the key theme of the 4-day meeting and such term appeared in the post-plenum announcement for 59 times.[1] Some dozens of topics were discussed during the plenary session, including regulations, urbanization, growth, and many more. While key reform ideas and directions were highlighted and agreed by the country leaders in principle, details of the respective execution plans were not detailed. It was not surprising to us since the plenary session only lasted for 4 days and it would not be feasible to talk about every detail due to the significant breadth of the topics. On the contrary, given the complexity of different issues, it will take time before all the arrangements are introduced, and it will require consistent effort by the country leaders to negotiate with a wide-range of stakeholders before the key operational plans will be announced.

Nevertheless, from its post-plenum announcement and government actions since March, the current regime has shown keen interest in taking the comprehensive reform agenda forward. The government has set a target to have “decisive result” by 2020 and the broad-ranged topics in the announcement showed that leaders of the Xi-Li regime are reform-minded and have shown eagerness in executing the plans in reform agenda. This could be cited from the repeated emphases by the leaders that instead of going after robust headline economic growth, stabilizing growth has become a key target of the government since they came into the office.

The agenda of this plenary session is one of the most – if not the most – challenging since China opened up again in 1978. In hindsight, we can vaguely define Deng Xiaoping’s “open-door” policy direction announced in 1978 and Zhu Rongji’s continuous effort during the 1990s that contributes to China’s eventual entry into the WTO as the most important reforms in China announced in the last 30 some years. The current reform agenda is built upon the legacies the success of the precedents; it touched up issues related to engaging the world economy, but also had deep discussion on internal issues, many that were not mentioned in previous regimes.

In the 8 months since March, the Xi-Li regime has shown strong determination and effort carrying the reform agenda. Recently, instead of having announcing new plans of reforms, Premier Li has used a regular meeting in October to follow up with the progress of numerous measures that was launched in the past months.[2] In the same meeting, Premier Li was cited to have asked for further acceleration and progress on reform and structural adjustment in 4Q2013.

Given the recent signals and evidence from the government, the current regime is likely to successfully take the reform effort forward. While the government will continue to follow the “top-layer design” approach, this current regime has shown a clear signal to us that it welcomes more competition in areas including certain so-called strategic industries.

While it is still unsure about the details of each and every step that government will take going forward, a more concrete plan could be on its way and it will be communicated officially.

...push toward a market-based economy...

The Xi-Li regime is open to adapt more market-based policies on various dimensions, such as the lending rate liberalization announced in July, and the proposal to reduce utility subsidies for certain sectors in October. It was mentioned in the post-plenum announcement also mentioned that China intends to deepen the reform of economic structure through managing the relationship between the government and market. The government believes such effort would be beneficial for better asset allocation and utilization, while SOEs traditionally dominating the sectors could see profit erosion.

China will welcome foreign companies to enter its market through removal of barriers to entry in certain sectors. In addition, the leaders have indicated their willingness to step up the government’s effort in the market reform through delegation of its power to appropriate levels, which would be useful in reducing administrative and other transaction costs. These show the government’s intention to take a less active role in the administration process and to focus on the rule-setting front.

As a continuation of the recently-announced proposal to tackle overcapacity issues in industries that involved many SOEs as well as private enterprises, Chinese leaders will continue to step up its effort to provide a level-playing field for private enterprises and SOEs, essentially allowing private firms to enter and compete for business in sectors traditionally led by state-owned companies (see Section C). For instance, discussions have touched upon letting private companies to be involved in more areas. Execution of these measures would allow the Chinese economy to become more market-oriented, and private sector development will become a highlight of the government’s agenda.

(1) Reform(改革) appeared 59 times in the Chinese version of the post-plenum announcement

(2) Ministry of Industry and Information Technology (October 2013)

These developments are clear signals to us that the Xi-Li government is determined to achieve sustainable growth through enhancing efficiency while adopting a market-based economic model. Such measures are positive development for the country to move towards a market-based economy.

...devoted to expanding international presence...

During the plenary session, it was also announced that the government will relax the restrictions on foreign participation by in some of these areas, in-line with the establishment of China (Shanghai) Free Trade Zone (SHFTZ).

Such development is reflective of the arising intention of the Chinese leaders to participate in new trade negotiations, including, but not limited to, the Trans-Pacific Partnership (TPP).

According to Lim, Elms, and Low (2012), TPP is "*intended to open markets to more competition than ever before between the partners in sectors ranging from goods and services to investment.*"[3] Although it was not clear whether China would be pursuing opportunities to join the TPP negotiation, opening up the sectors that are traditionally led by SOEs could be implicit signs of the intention, together with the launch of the SHFTZ (see Section C).

...providing an accommodative economic environment

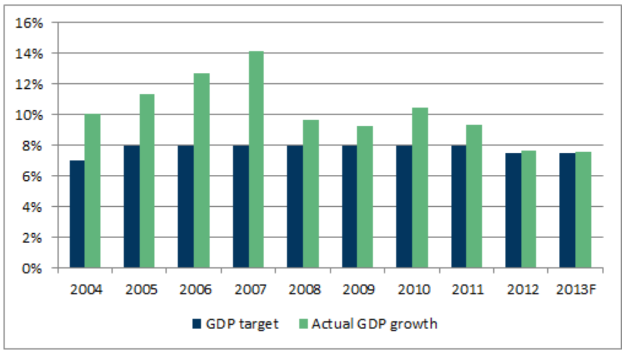
Coming into the plenary session, there have been signals that business environment will be stabilizing, if not improving. Premier Li flashed in a speech in Beijing in late October that the government and its agencies are ready to support the real economy through providing accommodative environment. Such tone is in line with the expressions in July, right after the SHIBOR-hike that led to market panic.[4] Indeed, after the June incident – which we regard as a stress-test platform – the PBoC has shown in late-September and late-October that it is the last resort for financial institutions in light of tightness in the interbank money market.

Prior to the plenary session, the government has introduced a range of so-called "mini-stimuli" to support businesses, particularly micro and small firms. While further introduction of these mini-stimuli may be deferred due to the recent signals of growth recovery – from headline GDP growth, to the sustained increase in property prices, to improving SOE profitability – the Chinese government has sent clear signals to the market that they will use this as a channel to provide a better-balanced growth platform across different segments in the society (see Section A).

Part III: What to expect

A. Moderating economic growth

Riding on its robust economic growth in the last decade, China is now the second largest economy in the world. Especially in the post-financial crisis era where most of the advanced economies have been troubled, China has become the engine of growth of the world economy and the world had all its attention on the path ahead.



Source: CEIC, Coface

From the announcement of the plenary session, it was stated clearly that the government is comfortable with the normalization of growth rate. Slower GDP growth was attributed by slower export growth together with weakening investment sentiment. Prior to the meeting, the leaders have repeatedly mentioned that GDP targeting will play a less important role going forward; the country leaders have mentioned that they would be referring to other indicators (e.g. employment, asset prices, etc) as they plan and implement policies. Particularly, instead of chasing double-digit GDP growth, the government has shown its intention to go after sustainable growth, which is compiled by higher efficiency and shifting growth driver (see Sections B and E).

Growth will stabilize in the short-run. Government leadership had mentioned in various occasions and reinforced the message in the plenary session that the government's GDP growth target for 2013 stayed at 7.5% (*Coface CRA*[5]*: A3; GDP forecast: 2013F, 7.5%; 2014F, 7%).* Key government officials including Premier Li Keqiang were quoted saying that the government is determined not to expand the government's fiscal deficit position. Together with the fact that China has registered a 7.6% YoY growth

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(3) The Trans-Pacific Partnership: A Quest for a Twenty-first-Century Trade Agreement (2012)

(4) When Shanghai Interbank Overnight Rate closed at over 13% on June 20, after average 2.509% during the first 5 months of the year

(5) Our Country Risk Assessment (CRA) is based on Coface's payment experience, and public information including marco and micro

during the first three quarters, the government is not likely to be launching any massive fiscal stimulus plan in the near-future.

Although it was made quite clearly that no massive stimulus plan is in sight in the short-run, the government should accelerate the launch of investment in infrastructure projects that have already been planned and budgeted. That will provide near-term support to the demand outlook of specific construction materials, including but not limited to steel and cement sectors.

In the medium-term, growth will be slower with the higher comparable base. While credit expansion has been a driver of growth in China during the last decade, it is bringing worries to investors and other stakeholders that it would eventually fuel a credit bubble. In light of this, the government should become less reliant to achieve economic growth through credit expansion. With the new growth model, the government is believed to be less likely to introduce aggressive stimulus plans – both fiscal and monetary – under normal circumstances in order to tame credit and debt pressures in the country.

China will continue to grow faster than 7% p.a in the medium-term. The government has set stabilizing growth as a key target going forward, along with job stabilization and prevention of asset bubbles. In a meeting on October 21, Premier Li has indicated that that 7.2% GDP growth is "absolutely necessary to create 10 million new jobs and to keep the unemployment rate at around 4%". Such figure is a good indicator of the government's new growth target in the medium-term. We can also turn to the growth target of 7% YoY growth as stated in the Twelfth Five-Year Plan (12^{th} FYP) as a reference point. These signs show us that the government has set a top-line growth target scenario that is range-bounded, and the 7%-target seems to be the lower-end of threshold. While there will be changes along the reform process, the government will only be taking active stimulating measures shall there be indication that growth falls below such benchmark.

Implication to businesses

In the near-term, with the acceleration of the launch of planned and budgeted infrastructure projects, infrastructure related industries are expected to see near-term boost on the demand side. These industries include, but not limited to, steel and cement. This has been somewhat reflected in recent data. For instance, crude steel production has picked by 9.7% YoY 9M2013, while production of infrastructure related products like railway-steel products (23.8% YoY) have seen more aggressive increases. With the potential introduction of new – but budgeted – projects, it is likely that the production of relevant products will continue to see support.

While inflation has not been a big issue in China during the first 9 months of 2013, it does not mean that it will not become an issue. Looking into recent trend of food prices and the low comparable base, inflation is likely to pick up in the rest of 2013. Top-ranked government officials have repeatedly said that prevention of outrun inflation would be a key objective of the government. It shows that although inflation is currently out of sight, it is not out of the minds of these policymakers. It is, therefore, believed that the government will be prudent in launching any supportive policies.

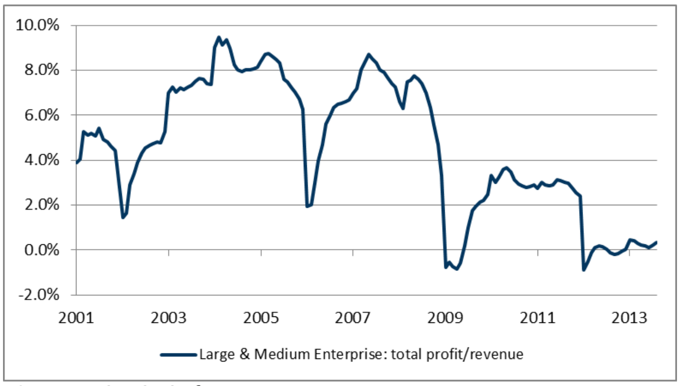
Top-ranked government officials have indicated that it is not the government's intention to exploit fiscal balance for growth. Due to structural changes including slowing growth and potentially tighter liquidity facilities for these industries, medium-term scenarios for the aforementioned industries will be bleak. Economic growth of China is expected to slow to a normalized level, which will likely touch 7% by the end of the 12^{th} FYP.

There could be a ripple effect as a result of the slower economic growth, however. Although a 7% annual growth rate is still impressive, especially for the size of the economy, such top-line economic growth would be the slowest level since 1990, which could potentially lead to weakening investor confidence and we should take note of that. Together with the potential liberalization of its currency and even capital account (see Section D), it could lead to capital outflow from the country, which could present big risks across all industries in the country.

Nevertheless, growing income, improving rule-base business environment, and improving production efficiencies are key positive contributors to the country's economic growth going forward. The Chinese government has indicated intention to change its growth model to become more consumption-driven, which should be positive for retail industries. Albeit potential margin erosion in traditional retail setting as a result of rising rental and labour costs, retail and consumers industries should still blossom with the growing wealth and income in China.

B. Actively tackling overcapacity issues

This is the part of the overarching plan of the Xi-Li regime to upgrade the Chinese economy through stabilizing growth, adjusting economic structure and promoting reforms. The government also intends to achieve it through promoting industrial restructuring priorities. In October, the State Council has issued a proposal that focuses on tackling the overcapacity situation in China.[6] While the proposal was intended to cover all sectors that face overcapacity situations, it has highlighted 5 particular sectors – steel, cement, aluminium, shipbuilding, and glassmaking – as the overcapacity situation has led to weak and inefficient industry performances.



Source: CEIC, Coface

In the post-plenum announcement, there was a large coverage on refining resource allocation in the country. Although the announcement did not relate such focus to a specific aspect, the officials are aware of how the current overcapacity situation could lead to systemic risks. With the tone of leaders broadly in-line with that we have seen from the proposal earlier in October, the government officials have shown clear determination to more actively tackle the overcapacity issue in various industries.

From the proposal in October, the government officials will tackle the issue from the supply and demand sides of the equation. The core idea is to adjust the equilibrium through digesting, transferring, integrating and dismantling existing supply and demand. Such changes will be facilitated by refining regulatory and administrative procedures.

From the supply side, among the potential ways to achieve it, the government officials expressed that the government would strengthen its effort to ban any expansionary plan in the industries that have existing overcapacity issues. The government will become tougher on existing capacities that were built illegally. As for existing outdated capacities, the government will introduce plans to help speed up the dismantling-process. Albeit the government officials agreed that the existing consolidation process through merger and acquisition led by leading SOEs had not been proved efficient, such process will still continue with alternation in the process.

As for demand side, government officials have indicated that stimulating domestic demand through improving demand-structure would be a key driver of change going forward. At the same time, it is also the government's intention to expand the industries' presence in the international market. The government is also likely to focus on improving quality of products and drive innovation in various industries. The government also proposed to increase transparency and introduce competition to the industries so to let the "market" to become the major driver of supply and demand.

The government has shown strong intention to reengineer the delegation of responsibility (i.e. government structure) in this area. On one hand, there were discussions on potentially less participation of the government in certain areas so to improve the monopolizing situation in some strategic industries; on the other hand, it was also proposed to centralize power for certain government functions. For instance, to deal with the overcapacity situation, under the context of having higher efficiency in governance, we have seen proposal to consolidate the administrative function at the central government level – by lessening the power of provincial and city governments.

Implication to businesses

Among the many key messages from the proposal in October, it caught our attention most by having explicitly said that "it will certainly cause short-term pain; and some industries could even be hurt quite structurally," signalling a strong tone that the government is ready to compromise near-term pain for long-term health of the economy. As a result of such gestures, it is estimated that the government will carry out the proposed actions in an accelerated manner comparing to the previous regime.

The large coverage related to resources allocation in the post-plenum announcement reconfirms us that the government is determined to tackle the overcapacity issue in China across basically all sectors that are facing overcapacity situations. Most notably, there are 5 highlighted industries that the government is targeting at – **steel, cement, aluminium, shipbuilding and glassmaking** – and we expect to see relatively quick development in the following areas:

(6) Ministry of Industry and Information Technology (22 October, 2013)

1) Speed-up ousting of outdated production capacity

In recent history, the Ministry of Industry and Information Technology have started announcing, albeit irregularly, companies that would have to dismantle their outdated production capacity within a certain timeframe since 2010. For instance, in July 2013, MIIT announced a list of 1400 companies across 19 industries (e.g. steel, ferroalloys, electrolytic aluminum, alcohol, MSG, copper smelting, flat glassmaking, cement, paper, etc.) that would have to dismantle specific outdated capacity by the end of this year. The government officials have proposed to start publishing lists of corporations with outdated production facilities to be dismantled on a regular basis.

It was suggested in the proposal that the government will conduct more frequent investigation on land usage of industrial plants, and will penalize firms that conduct activities outside of the permitted area. If the government puts regularity to such practice, the dismantling process will be strictly followed, which would speed up solving the overcapacity issues.

The government will also launch some soft measures to encourage the existing industry participants to follow the government's direction, using financial institutions as the intermediaries. For those industries with overcapacity issues, the government is expected to speed up capacity ousting by encouraging activities like transformation of businesses, consolidation, and overseas expansion through accommodative credit environment.

2) Cease of capacity expansion

Perhaps, it was disappointing for the market as the post-plenum announcement did not specifically mentioned any confirmed measures of ceasing capacity expansion. Nonetheless, it was discussed in the proposal in October that the government would start the investigation process on companies that have illegal expansionary projects that have been completed or underway. It is also the government's intention to strengthen credit control on projects that do not have appropriate permits.

From our on-the-ground conversations with businesses in some of aforementioned sectors, we have heard that the government has already told the agencies to halt the permit approval process. While they are still receiving loans from banks for normal operational activities, some SOE banks have stopped extending banking facilities for capacity building projects.

3) Higher environmental standard and reduced subsidies

There will be higher environmental standards going forward (see Section E). This is in-line with the government's strong determination to pursue sustainable economic growth. On one hand, such policy will help improve the environment in China; on the other hand, it will also accelerate firms' action to dismantle outdated and inefficient production facilities.

It was suggested in the October proposal that the government intends to limit subsides provided by local governments. A potential way of carrying it out is to reduce subsidies on resources (e.g. water, energy, power, etc), which will hurt the companies' profit directly. Together with the fact that some of these industries are currently seeing very thin margins, it is believed that some less-competitive players with outdated production facilities will see rising pressure going forward. Depending on what measures it will weigh on different industries, higher environmental standards could be raising fixed cost as well as variable cost of production for industry players.

In general, smaller-scaled industry participants with inefficient production capacities will be facing increasing pressure in the medium-term. Although there are policies discussed in the plenary session that could potentially increase domestic demand, it would take time for such incentive-driven policy to materialize and be sustainable.

C. Establishment of the China (Shanghai) Free Trade Zone to engage the global economy

The post-plenum announcement mentioned about engaging a globalized world. Particularly, the establishment of the SHFTZ was cited as an important medium to achieve such purpose.

The launch of the SHFTZ was first announced by the government in July 2013. The plan was endorsed by Premier Li who wanted to make use of the zone as a medium to project and experience how China could improve its economic structure. Such establishment is symbolic that the country leaders are supportive of the China-U.S. Bilateral Investment Treaty (BIT) talks, and there are increasing discussions in the local academia that the country is planning to participate in TPP negotiations.

The SHFTZ, which covers 29 km^2, spans over 4 existing tariff-free zones. When it was set up, the State Council has identified 6 focus areas in services, which the opening up of such industries would be tested in the zone. Elimination or relaxation (e.g. foreign firm to form joint-venture with domestic company) of restriction by foreign investments is introduced in these sectors. They are: i) financial services (i.e. banks, special health and medical insurance, and financial leasing); ii) shipping (i.e. cargo transportation and international vessel management); iii) special telecommunication services (i.e. value-added communication and entertainment/game console); iv) professional services (e.g. legal services, credit analysis, travel agency, human resources management, asset management, design and construction); v) cultural services (i.e. performance and public entertainment); and vi) social services (e.g. medical services and education and vocation training).

Although some people are expecting the SHFTZ to be somewhat similar to the Special Economic Zone (SEZ) in Shenzhen launched about 30 years ago, it is not entirely true. While both of these zones were set up with an intention to test-run a new economic structure with opening up to the external world in their respective time, there are important differences.

First and foremost, as indicated above, the SHFTZ is primarily focusing on services area, while the SEZ in Shenzhen has largely become the world's renowned manufacturing hub. In the last few decades, China has built its economic power on the development of SEZs like Shenzhen, utilizing the abundance of low-cost non-transferable factor prices including land and labour. However, going forward, it is the government's intention to structure the new growth model that is ready to climb up the value-chain, either to upstream (e.g. design) or downstream (e.g. post-sales services). The establishment and development of the SHFTZ is perfectly in-line with the government's intention to adjust the country's growth model to a more sustainable one.

Moreover, while the success of the SEZ in Shenzhen has led to development of numerous SEZs in other regions, policymakers have shown reluctance to establish another FTZ similar to the one in Shanghai, despite the strong push by various provinces including Tianjin and Guangdong. Such indication is pointing to an expanded – perhaps, country-wide – adoption of the successful policies launched in SHFTZ if they are proved workable instead of carrying out multiple test-points. Such development is an indication to us that top officials in the Xi-Li regime have a clear vision to engage the global economy, potentially through participation in trade talks like TPP.

Policymakers and business leaders from around the world are still eager to take the long-stalled Doha Round discussion forward, particularly by restarting a discussion on trade facilitation using the 9th WTO Ministerial Conference in Bali as a platform. However, although the single undertaking rule exists for the reasons to make sure that everyone's opinion matters, the "nothing is agreed until everything is agreed" nature of rule is making it difficult to expect progress for the Doha round. For comparison, WTO had 76 members on 1 January, 1995 – when the WTO was first launched – but it currently has 159 members with Tajikistan entry in March 2013.[7]

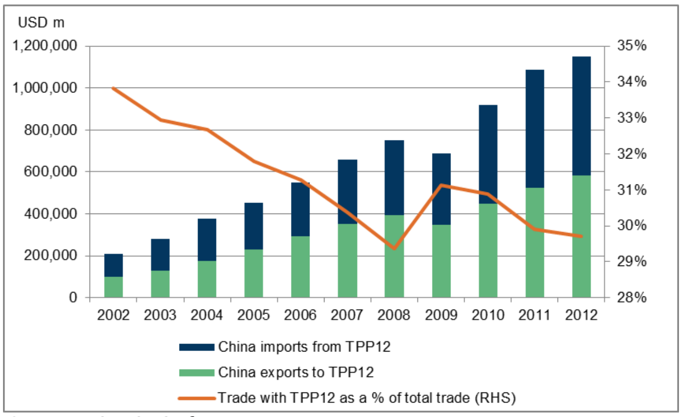
Such a different member structure is bringing increased complexity, and it is a major driver of the development of TPP – among the many other regional and bilateral free-trade agreements – as it is being pushed forward to become the new standard of trade agreements. While there were indications in the earlier stages that the Chinese leaders were reluctant to join the TPP negotiation, recent signs have shown an adjusted tone, together with the establishment of the SHFTZ.

Besides the tariff related benefits TPP members may enjoy that most of the other separate free trade agreements (FTAs) could offer, TPP aims at boosting trade among its members through setting out strict rule of origins (ROO) so member countries can maximize their profit through their membership in TPP. While there are still on-going debates on whether or not the so-called "yarn forward" ROO should be applied and/or across industries in the TPP negotiation,[8] the expanding interest and increasing involvement of other countries could be a key reason why China is becoming increasing interested in joining the negotiation. In 2012, gross trade value between China and the so-called TPP12[9] – countries that are part of the TPP negotiation – amounted to US$1149b. Albeit the declining trend, China's trade with the so-called TPP12 remains at almost a-third of China's total external trade.

(7) World Trade Organization

(8) United States Association of Importers of Textiles and Apparel (10 June 2013)

(9) TPP12 = Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, U.S., Vietnam



Source: CEIC, Coface

During his trip to Nanning in September, Premier Li Keqiang was quoted by the media saying that China "is willing to discuss exchanges and interactions with frameworks such as the Trans-Pacific Partnership Agreement."[10] According to China Daily, Long Yongtu, a former chief negotiator for China's entry into WTO, commented on November 1 that "the Chinese side is also taking an active interest in the TPP. When it's ready, we are going to launch negotiations with the US."[11] Long's view is seconded by Chi Fulin, president of the China Institute for Reform and Development, who expressed in the same occasion that he believed China's leaders had shown strong interest in engaging the US in such trade talk.

If the opinions of these experts materialize, the development of the SHFTZ will be a major contributor to China's entry to TPP negotiation, which will be a significant drive of the bigger reform agenda that involves SOE, interest rate, exchange rate, etc.

Implication to businesses

The establishment of the SHFTZ is clearly symbolic and significant, but it is still unsure what it can achieve.

As a first take, the announced Negative List[12] was long and quite exhaustive, although it "only" covers 190 subclasses among 1,069 industry subclasses in China classification system.[13] Moreover, the details of practical administrative measures remained ambiguous. From our conversations with non-domestic companies, while they are hopeful about the potentials of the idea and the development of the SHFTZ, they remain doubtful about what can be achieved from it. Among the questions, the business executives we talked to seem to have doubt about how representative the findings from the SHFTZ can be for the entire country.

For instance, in our conversation with Mr Tse, president of a Shanghai-based architect firm, we were told that although the idea of setting up an office in the SHFTZ could be of interest, he would prefer knowing more about the specific details and requirement before making such decision. Specifically, Mr. Tse told us that he would believe it would require intensive work on administrative measures before the desired framework can be laid out, and it would be unwise to just start an office without knowing what would be the prospect of the area.

Such practical considerations are valid and could very much be shared among the other businesses. Despite the potentials of further development of interest rate and exchanging rate liberalization within the zone, it remains debatable about the feasibility and what administrative measures have to be in place to build a separate system within the arguably most international city in China. Using interest rate and exchange rate liberalization as an example, it would be a question to the policymakers to prevent arbitrage activities between the SHFTZ and areas outside for the zone.

Observing from the setup of the SHFTZ, determination of the Chinese government to climb up the value chain is very clear. From the establishment of the SHFTZ and the business focus as promoted by the government, it has shown strong signals that the Chinese leaders are ready to provide accommodative business environment for those that are positioned to capture higher value-added within the country. While officials have been talking about climbing up the value-chain for the last few years, services industries are clear winners from the establishment of the SHFTZ.

With the strong focus of service industries, on a second-degree level, industries that engage in less value-adding process of the supply chains (e.g. manufacturers) could face potential challenges in terms of policy environment, in additional to the rising wages, real exchange rate appreciation (see section D), stricter environmental regulations (see section E), and other factors.

While the leaders' intention to participate in trade talk is a positive sign to the country as a whole, it is worth noting that it is never an easy task to digest the existing trade agreements. In other words, the signing of different trade agreements could have mixed implications for various businesses, particularly if TPP turns out to be a very complex trade agreement that requires exhaustive administrative costs.

(10) South China Morning Post (4 September 2013)
(11) China Daily (1 November 2013)
(12) Shanghai Government (29 September, 2013)
(13) Lanbo Yang and Steven J. Dickinson (24 October, 2013)

Take the debated ROO as an example. On one hand, if China eventually does not join TPP, all trade-related sectors in China would be severely hurt if the strict "yarn forward" ROO is applied across the board. In a nutshell, such ROO encourages companies to build their supply chains around tax incentives for using all materials only coming out of member countries, instead of optimizing their supply chain by the other dimensions (e.g. cost, quality, time, economy of scale, etc.), where China possess competitive advantage. On the other hand, if China eventually becomes a member of the TPP, smaller businesses could still be hurt by the complex administrative work (e.g. making sure that all components in the products are from TPP member countries) involved in the process.

If we take a look at the existing FTAs between China and the other economies, we'd find that China, in fact, have quite a few existing FTAs or participating in FTA talks with some economies that are present in the TPP negotiations. If the eventual TPP agreement is not compromising with the existing agreements, the duplication of such agreements would add administrative costs to businesses.

China's Existing Free Trade Agreements	
China-ASEAN FTA	Mainland and Hong Kong Closer Economic and Partnership Arrangement
China-Pakistan FTA	Mainland and Macau Closer Economic and Partnership Arrangement
China-Chile FTA	China-Costa Rica FTA
China-New Zealand FTA	China-Iceland FTA
China-Singapore FTA	China-Switzerland FTA
China-Peru FTA	
Free Trade Agreements under Negotiation	
China-GCC(Gulf Cooperation Council) FTA	China-Norway FTA
China-Australia FTA	
Free Trade Agreements under Consideration	
China-India Regional Trade Arrangement Joint Feasibility Study	China-Japan-Korea Joint Study
China-Korea FTA Joint Feasibility Study	
Preferential Trade Agreement	
Asia-Pacific Trade Agreement	

Source: Ministry of Commerce of China

In general, larger companies and conglomerates could have a separate department or hire professional services providers to digest the impact of policies. However, particularly for smaller companies, the *spaghetti bowl* situation could be adding costs and pressure to the already-complicated administrative work.

When the trade agreements come in effect, highly-protected sectors (e.g. financial services, automobiles, food processing) in these member economies will be negatively hurt in the short-run as the relaxation of protective measures come in place. With lower trade restrictions and tariffs, industries and countries will be producing according to their competitive advantages. For instance, as China currently requires foreign-branded but domestic-made vehicles to be produced by foreign-domestic joint ventures, the relaxation of such rule could potentially hurt Chinese automakers, especially for the domestic brands that focus on higher-end segment that are dominated by foreign brands.

Nevertheless, if China is determined to participate in the TPP negotiation, it will help accelerate China's reform agenda. In the medium-term, we shall expect acceleration of large-scaled reforms in the entire Chinese market, involving most – if not all – enterprises with different stakeholder structures as TPP requires participating countries to put foreign and domestic market participants on a level-playing field. Further enhancement of the rule of law in the country shall also be seen, and intellectual property right would be better protected. Such development would undoubtedly be beneficial to China in the long-run, and foreign companies would become more confident in investing in China. However, the potentially wide-spread social impacts in China (e.g. employment, competitiveness, etc.) may become a major deciding factor.

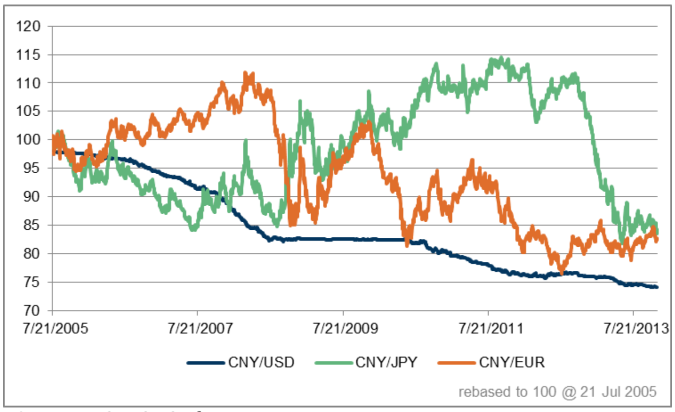
D. On-going RMB Internationalization

The signal of a more open economy confirmed the direction of taking the RMB internationalization process forward. Together with the announcements in October – including Hong Kong Monetary Authority's chief Norman Chan said that it is likely to lift the RMB20000-a-day limit on currency exchange for Hong Kong people[14], signings of swap agreement with European Central Bank (ECB) and RQFII arrangement with Singapore and London, UK – these moves are clear signs that the Chinese government is ready to brush up its efforts to internationalize its currency.

RMB internationalization is a long-term process and the country leaders will continue to take all the steps cautiously. Clearly, one of the ultimate goals of RMB

(14) South China Morning Post (17 October, 2013)

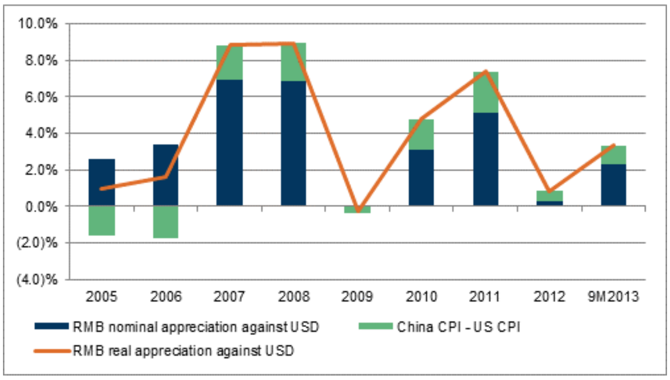
internationalization is to make it a reserve currency for central banks, and perhaps even be included in the special drawing rights (SDRs) currency basket – which now only contains the Euro, Japanese yen, British pound, and USD – defined by the International Monetary Fund.[15] To make RMB a reserve currency, it has vast impacts on various dimensions, and it would – at least to a certain extent – require full-convertibility and broad usability of the currency. This implies that China will need to liberalize its capital account and promote the usage of the currency externally at the same time. A lot of uncertainties will be involved during the process, including but not limited to potential exchange rate fluctuation and creation/destruction of asset bubbles. Under such considerations, the Chinese government is ready to pace the process in an optimal manner and there should not be changes in such approach in the near-term.



Source: CEIC, Coface

Expectedly, China's intention to expand the usage of its currency will likely expose it to currency fluctuation – or more precisely, appreciation pressure. We can vaguely define RMB internationalization has begun in July 2005, when the PBoC allowed the RMB to have a one-off 2% appreciation against the USD. Since then, the RMB/USD cross-rate has declined by over 25%, and there are still voices – most recently and notably from the US Treasury – saying that the RMB is undervalued and should appreciate.[16]

From now until whenever RMB will become a fully tradable currency, there will be continual effort by external economies to push for RMB appreciation. However, we need to bear in mind that nominal exchange rate appreciation does not explain the whole story, while real exchange rate appreciation[17] would essentially be a more appropriate measure of exchange rate fluctuation as it "seeks to measure the value of a country's goods against those of another country".[18] As a result of the *Balassa-Samuelson effect*, much cheaper prices of non-tradable assets in China (e.g. property, land, labour, etc.) makes inflation higher in China than that in developed economies like the US. Such element, which is not captured in the illustration of simple nominal exchange rate, should also be considered when we look into changes in foreign exchange markets. The real exchange rate appreciation of RMB against the USD in the last few years is in fact higher than what is reflected in the nominal exchange rate fluctuation.



Source: CEIC, Coface

Regardless of which direction the RMB will move going forward, the recent developments are positive for the economies involved, particularly for China. The recent moves are positive continuation of the on-going RMB internationalization process, which, in the near-term, aims at promoting usage of the country's currency in trade and investment activities in foreign economies. The increasing usage implies increasing acceptability, which would help reflect the overall demand of the currency in foreign markets, allowing the Chinese government to have better points of reference when assessing the risks and benefits of RMB internationalization.

In the medium-term, after the RMB will have gained popularity among international users, China will need to come up with a well-designed operational system to deal with the opening up of the capital account. The opening up and increasing convertibility of capital account would be a challenging process.

Since its opening up, foreign capital has been flowing into the country through trade and investment activities, while the outflow of such capital has been limited. Foreign reserve of the country has climbed to over US$3.66 trillion, comparing to the US$156 billion as of January 2000. The prosperity of China is certainly a major contributor to such phenomenon, but the tight capital control was not a non-factor. It is argued my many scholars, including Nobel Laureate Joseph Stiglitz (2010)[19], that such the capital control

(15) International Monetary Fund

(16) U.S. Treasury Says Yuan Hasn't Strengthened as Needed, Bloomberg (30 October, 2013)

*(17) Real exchange rate = (nominal exchange rate * domestic aggregate price level) / (foreign aggregate price level)*

(18) Why Real Exchange Rates, IMF (2007)

(19) Risk and global economic architecture: Why full financial integration may be undesirable (2010)

mechanism could be useful to keep capital with a country for various purposes.

Even if no changes is made to the capital account in China, the increase in foreign reserve will become slower due to fundamental reasons. Comparing to the other countries, factor costs in China have increased quickly in the last few decades. Although growth rate of the economy is still higher than that in the other emerging economies, the growth rate is trending down. It could contribute to capital outflow if the capital control will be eased or even lifted.

While such scenario is inevitable if China wants to become an open economy, uncontrolled capital flight would cast doubts on the outlook of the economy, and the government would not risk it until it is proved to be the appropriate time.

Implication to businesses

In the near-term, if the aforementioned announcement shall materialize, Hong Kong can reaffirm its position as a leading offshore RMB centre by testing out the demand of RMB in the city. The key beneficiary should be financial institutions that sell RMB-denominated products in Hong Kong, as full convertibility of RMB for Hong Kong people could induce higher demand for such products.

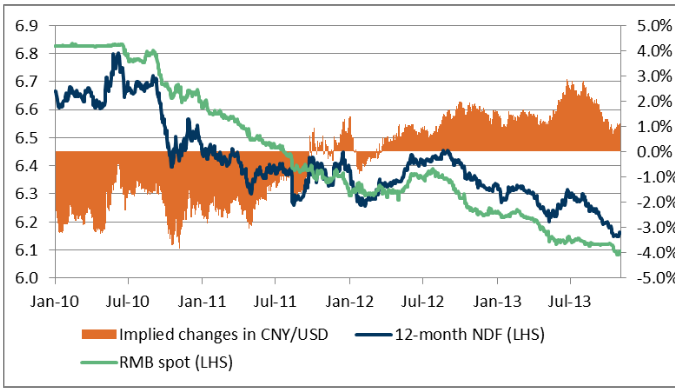
For London and Singapore, the RQFII arrangements would provide another investment channel for the investors, despite the demand of such investment vehicles remains unclear. Financial institutions in these economies, again, will become the key beneficiaries of such development. Such institutions can refer to the development of RMB businesses in Hong Kong as a reference point.

As for countries in the Eurozone, the swap agreement between ECB and PBoC was important, particularly because the Eurozone and China are significant trading partners for each other; the swap agreement will supply the RMB liquidity demanded by businesses, providing another medium for the business to hedge against potential currency fluctuation.

Although the daily fluctuation range for RMB against the USD is now set at 1%, such restriction could be relaxed in the future, potentially in 2014 if not sooner. In the medium-term, wider usage and less restrictive measures on the movement of the currency could lead to higher volatility of the exchange rate.

Albeit weakening RMB appreciation expectation is implied by the non-deliverable forward (NDF)[20] market (i.e. it currently implies USD to appreciate against the RMB), RMB will continue to strengthen against the US dollar due to its relative sound growth prospect.

Although higher volatility is expected, RMB appreciation will remain modest at 4% in real-term against the USD in 2014. As exchange rate fluctuation would directly impact investor confidence and beyond, the government will continue to stabilize shocks through foreign exchange market operation. It would be beneficial to exporters to China, while Chinese manufacturers will be adversely impacted by the RMB appreciation as their products become more expensive, but improving efficiency could compensate such impact. Provided that they have access to RMB, foreign businesses that purchase from and sell to China should start invoicing and settling their bills in RMB to hedge against currency fluctuation.



Source: Bloomberg, Coface

E. Environment-friendly policies on the way

China has experienced a high-growth pattern in the last decade or so, relying on heavy investments in various industries. While such investments have brought the strong economic growth, it also brought along the high social cost to the country, including but not limited to air and water pollution. According to the Energy Information Administration (2011), China was the biggest emission producer in 2009.[21] Among the other reports, a report released by the World Health Organization in September suggested that Beijing is the 47th most polluted city in the world, among the 1099 cities surveyed.[22] Country leaders are well aware of the situation, and have voiced their opinion on potential measures to contain the situation from worsening. For instance, in the plenary session, it

(20) Treasury Markets Association

(21) Energy Information Administration (2011)

(22) World Health Organization (September 2013)

was believed that Chinese leaders have set out their plans on how to reduce pollution by bringing in higher efficiency to certainty industries. The leaders also suggested relocation of certain production capacities in certain cities and provinces to reduce logistics cost and avoid excess production.

After having seen severe air pollution during the earlier months in Beijing and other regions earlier this year, the government said in September that consumers will be more responsible for costs associated with industrial pollution, which could be reflected it the increasing cost as a result of stricter fuel standards. Potentially, the government will implement it through reducing subsidies on power and energy, resulting in higher fuel prices. In such regard, the National Development and Reform Commission (NDRC) made a comment in late-September that the increasing costs would be shared between consumers and producers, which include companies in various industries.

Particularly, NDRC has attributed the PM2.5 emission to the climbing automobile ownership in China. According to Beijing Review, the city has launched a plan that targeted to reduce the density of PM2.5 by 2015 during a 5-year period (2013-2017).[23] One way to achieve the goal, according to the report, is to use natural gas as a substitute to coal-power generation and the city has invested over RMB28b on the construction of such gas station that is targeted to start running by the end of 2014.

The aforementioned review also mentioned that the Beijing government is focus on reducing emission coming from vehicles. Some ways of doing it is to promote vehicles that run on alternative energy (e.g. LNG, electricity, etc.) and replacing old vehicles that tend to emit more pollutants. It was also mentioned that Mr. Li Kunsheng, Director of the Vehicles Emission Management Division in the Beijing Environmental Protection Bureau, have shared with them that the city intended to contain the number of vehicles in the city to be no more than 6 million units by 2017.

Implication to businesses

In fact, this ties hand-in-hand to the government's intention to tackle overcapacity issue in various sectors (see section B). With the intention to dismantle outdated production facilities in the sectors, the government can hit two birds with one stone. When the "outdated" production facilities are ousted, it is believed that only the newer and relatively more efficient (e.g. input-output ratio) production facilities that are supposedly more environmentally friendly (e.g. less resources consumption needed, less pollutants are released) will be left.

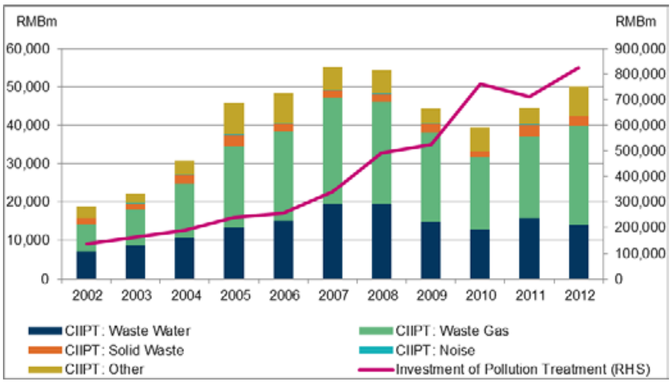
Ministry of Environmental Protection Ministry announced in late-October that it will conduct special inspection during October 2013 and March 2013 around key areas, including but not limited to Beijing and Tianjin areas, Yangzi River Delta, Pearl River Delta, etc. It was said that the government will be strict on these inspection. Together with the other counterparties, the government agency can presumably use this to find out where inappropriate activities appear and address on committing to a national standard. Such measures would improve efficiency ofindustries of various industries (e.g. steel, cement, aluminum, coal, etc.), but would hurt some smaller and inefficient players due to potentially higher administrative cost, and would substantially hurt the industry (e.g. coal, steel, cement, etc.) participants who do not already comply with the regulations.

China has signalled their intentional to reduce the emission of pollutants. One of the key sources of pollution is the use of coal, and China has aimed at reducing the reliance on this form of power. According to China's 12th FYP for the coal industry, it was designed that to limit coal consumption to 3.9 billion metric tons (comparable to 3.2 billion metric tons in 2010). This could be a challenge for the Chinese government to achieve such goal as it is broadly estimated that coal consumption to have exceeded 3.6 trillion metric tons in 2012.[24]

At the same time, the Chinese government has been putting increasing focus on pollution treatment and that would be supportive to related industries. As of the end of 2012, annual investment of pollution treatment was amounted to RMB825b, growing at 19.7% compound annual growth rate (CAGR) since 2002. Besides putting much of the investment into urban environmental infrastructure (i.e. RMB506b in 2012), the government has also invested a respectable amount into industrial pollution treatment. The completed investment of industrial pollution treatment (CIIPT) grew 12.6% YoY in 2012, with much of the increase coming out from treatment on waste gas.

(23) Beijing Review (Issue 46)

(24) Estimated coal consumption = production of crude coke + net import of "Coal, Coke and Briquette"



Source: CEIC, Coface

Besides investing on the infrastructure development, the Chinese government will continue to launch regulatory measures to prevent the environment from getting worse. In an interview with Beijing Review, Li Kunsheng said that the Beijing government "will further enhance the emission standard for new cars and accelerate the retirement of vehicles". Such policy design could be beneficial for certain players in the automobile-related industry as it could stimulate replacement demand on top of demand for new vehicles – for instance, as a result of increasing income – which would add steam to the strong 18.2% CAGR growth of motor vehicles in China between 2002 and 2012.

Although we are optimistic about the increasing income and growing middle class in China, policy risk is high for automobile sector due to the government's determination to tackle pollution issues (see Country Risk Panorama Autumn 2013).[25] Chinese officials' focus on sustainable growth will be another exogenous factor on affecting automobile demand and, as reported by People's Daily in September, the Beijing government will be introducing car registration limit in November 2013 – which will be effective in 2014.[26] Such implementation of purchase restriction – together with the high cost of purchasing a car and running it for 3 years in the country[27] – could neutralize the positive effect from the aforementioned policy on the automobile industry.

Part IV: Going forward

The Xi-Li regime is evidently reform-minded, and they will be launching various measures on various fronts. The policy and business landscapes in the Chinese economy are expected to experience changes going forward, and on a relative basis, businesses should expect policy changes to come quicker than the previous regimes, as the success in the past has set the platform for further development.

Fairly quickly after the plenary session, on November 15, the government published their decision the officals have come aross during the meeting ("*the Decision*"), covering 60 measures.[28] Such gesture is a sign that the government is addressing the reform agenda with high priority, and it is ready to execute the plans accordingly.

Although headline GDP growth is expected to moderate going forward, the government should continue to accelerate its reform process. For instance, the government has already announced plans to lift the long-held one-child policy for families which either parent is a single child, which could be a remedy to what is broadly believed to be a declining youth population in the country. Such policies will be beneficial to the country's long-term development.

With some industries loaded with outdated production facilities, overcapacity issues have been underwhelming industries with extremely fragile fundamentals (e.g. the low profitability of the steel industry). The government has set out very concrete plans to dismantle these outdated facilities, and the streamlined administrative procedures will accelerate the process.

Financial and social reform related to dominant industry-players will also continue to move forward, as the government has addressed to refine the financing of social projects in *the Decision*. By 2020, SOEs will need to transfer 30% of the profits generated from using state capital to public finance for protecting and improving people's well-being. Although it will be a relatively long process, it is addressing the worries that the government would need to expand its budget deficit to support the growing demand of public finances. Such policy will, in turn, be changing the investment landscape in China. With the government's decision to make SOEs transfer 30% of the profit to public finaces (e.g. stakeholders), it could mean that such practice will later be expaneded toprivately-owned firms in the country.

At the same time, property rights will also be enhanced through the on-going urbanization process in China. During the urbanization process, the government will address on the use of land properly. Although it remains unknown how it can be carried out, *the Decision* has shown the govenrment's intention to strengthen farmers' right to operate on and profit from their assets (e.g. farm land). The government has also expressed their intention to develop a better system so the farmers can collateralize and inherit their ownership properly.

(25) Coface (Autumn 2013)

(26) People's Daily (3 September, 2014)

(27) The Economist (April 2013)

(28) The decision on major issues concerning comprehensively deepening reforms

Development in the SHFTZ will continue to be a driver of change for the Chinese economy to become more open to the external world. *The Decision* said that the development of the SHFTZ will be used as a channel to further engage the external economies and the development of the SHFTZ will see support from the State Council. The SHFTZ will be used as a site where the government can test-run policies where set domestic and international players on a level playing field, and justify a pace that the country should adopt in terms of opening up.

An open-economy will also put focus on reaching out to other economies, and the Chinese leaders have two-way flows of investment in mind: besides putting focus on attracting investments into the country, the document shows signs that country leaders intend to speed up overseas investments going forward. Chinese overseas investment will continue to take an increasing important role on a global platform and such roapmap will include expanded cooperations between China and regions including the special administrative regions of Hong Kong, Macau, and others.

As the Chinese economy continue to grow, RMB usage will continue to expand and higher volatility could also be expected. We expect the RMB to appreciate 4% against the USD in real terms in 2014. To hedge against the potentially increasing volatility, businesses can start invoicing and settling the bills using RMB.

To prevent the environment from worsening, more regulations on adjusting the pricing of resources and improving the business environment are on the way. T*he Decision* has also stated that the government would push forward reform on pricing of resources, including water, petroleum, natural gas, electricity, transportation, telecommunication, etc. Together with the government's address on improving usage and protection of intellectual property, the business environment should be improving for existing businesses and potential foreign investors, while investment on research and development should continue to see positive support.