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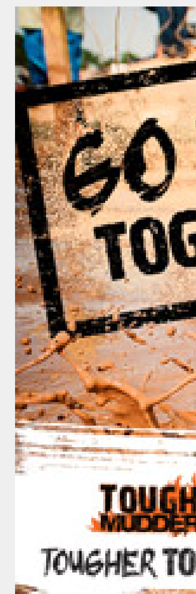
Part 1: Reforming China – Rebooting the Economic Engine

By Satyajit Das on May 9, 2016



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Over the last 35 years, China has emerged as a major global economy, with average annual growth rates of 9.7% which have been pivotal in helping raise between 400 and 600 million Chinese out of poverty.

Commentators have run out of hyperbole to describe the development. Justin Lin Yifu, a former chief economist at the World Bank, referred to it as "*a miracle unprecedented in human history*". But China's growth is not unprecedented. Japan, Germany and many emerging countries, especially in South East Asia, experienced similar growth rates and rises in living standards in the post-World War 2 era. Now like many of these countries, China faces serious challenges to maintain it rate of development.

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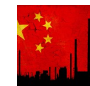

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Central to China's economy reform agenda is a shift from debt driven investment to consumption to drive growth.

China's development has been driven by investment, which has increased from around 35% of Gross Domestic Product ("GDP") to around 45-50% since the early 1980s. Around half of the investment is in property.

China's infrastructure stock is above the global average, comparable to that of developed countries. Its level of annual infrastructure investment is far greater than the US or Europe but also than other emerging markets, double that of India and around four times that of Latin America. China's investment levels are also 10-15% of GDP higher than comparable countries, such as Japan and South Korea, at the equivalent stage of development.

In recent year, China's central government has sought to rebalance the share of GDP contributed by consumption and investment, making in former Premier Wen's words: "*greater effort to enhance the role of domestic demand, especially final consumption*". The task is difficult.

First, the scale of adjustment is large. As

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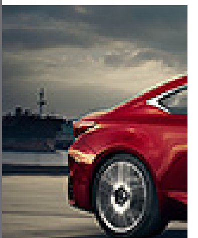

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China watcher Michael Pettis has stated repeatedly, the low existing base means the level of consumption growth needed to rebalance China is formidable.

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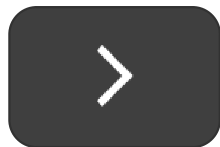

China's consumption has not been static, growing strongly at around 8% per annum over the last decade. However, the growth in consumer spending has been slower than that of the overall economy and the increase in gross fixed investment, an average annual growth of over 13% per annum, resulting in the share of private consumption in GDP falling to around 35% from around 45-50%.

If China grows at 8% per annum, consumption needs to grow by around 11% (3% above growth) to increase the share of consumption from 35% to 36% of GDP in a year. Assuming a growth rate of 8% and consumption increases of 11%, it would take around 5 years to increase consumption to 40% of GDP. If growth slows, then the difficulty of the task increases.

Second, legacy issues of rapid expansion and excessive investment will need to be managed. Many projects have dubious economics. The charges for items, like high speed trains, toll roads etc., required to recover the capital cost and operating expenses are beyond the capacity of

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users. Many investments will not generate sufficient revenues to repay the borrowings used to finance them, resulting in potential losses to lenders.

Third, boosting consumption will reduce savings, affecting the deposit base and cost of funding of Chinese banks which will reduce their flexibility in managing rising losses from bad loans. It will also require a significant boost in household income, which will affect the profitability of Chinese companies which already operate on thin margins and are struggling to remain cost competitive globally. It will necessitate investment in social welfare infrastructure, which will make claims on public finances.

Fourth, the rebalance will result in slower growth, at least during the period of transition, reflecting the reduction in the growth rate of or decline in investment levels. The resulting economic slowdown will further compound the identified challenges.

These difficulties mean that the temptation for China's leaders is to try to continue a strategy of debt fuelled investment, at least until it is absolutely impossible.

Rebooting SOEs

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China's SOE sector and China's industrial structure, which favour investment driven growth and large projects, need reform.

China has approximately 150,000 SOEs which control around 50% of industrial assets and employ around 20% of the workforce, contributing around one third of total economic value added. In reality, probably only around 50 of the 1,500 listed companies on the two Chinese stock exchanges are genuinely private businesses.

The SOEs enjoy several advantages.

First, key sectors of the economy, such as construction, infrastructure, finance and banking, insurance, resources, media and telecommunications, are reserved for SOEs. A system of licenses and permits controlled by various levels of governments and the Chinese Communist Party ("CCP") (rivalling that of India's *License Raj*) guarantees government controlled firms a major role in economic activity.

Second, SOEs enjoy preferential access to finance from state controlled financial institutions, receive around 60% of all bank loans and over 75% of the country's capital. The SOEs benefit from low cost of this capital, reflecting government support

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and their often monopoly or protected market positions.

Third, SOEs benefit from a range of subsidies, ranging from tax benefits, subsidized input costs and preferred procurement position for government contracts in addition to low cost capital.

Usha Haley and George Haley in their 2013 book *Subsidies to Chinese Industry found* that between 1985 and 2005 the biggest SOEs alone received around US$300 billion in subsidies. But the actual level of subsidies may be much higher. A China think tank Unirule argues that SOEs received a subsidy of around US$640 billion between 2001 and 2009, from just not having to pay for the cost of land.

Fourth, the SOEs pay low dividends, preferring to reinvest earnings, sometime in diverse, unrelated businesses.

Despite these significant competitive advantages, the profitability of SOEs lags well behind that of the 4-5 million private sector firms, which are far more important in terms of employment, tax receipts and output. These private sector firms are responsible for about 80% of China's urban employment and 90% of net new job creation as well as two-thirds of total fixed-asset investment.

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Opening Up

The large role played by frequently large, unproductive and unaccountable SOEs distorts capital allocation and economic and financial inefficiencies. Protected SOEs frequently do not pursue profits or greater efficiency, choosing instead (with tacit government support) to increase size, diversify, undertake foreign acquisition and acquire new technology.

It has contributed to a build-up of overcapacity in many industries. One notable case was over investment in solar energy, pursuant to a government diktat to increase exposure to renewable clean energy. It resulted in a global glut of solar panels and the bankruptcy of Chinese manufacturers such as Suntech.

Local private sector and foreign businesses find it difficult to compete with large dominant SOEs, resulting in higher prices and limited product choice, which must borne by Chinese citizens.

The dominant role of SOEs, which favour heavy industry, may impede the development of China's service sector. The Chinese government, in a moment of uncharacteristic candour, admitted to failing to meet targets in relation to service industries, which account for 40-

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45% of its GDP and 35% of its employment, well below the 60% or more in countries at a comparable stage of development.

Successive governments have recognized the need to reform SOEs. Following the 1993 plenum, then premier Zhu Rongji led a program whereby the number of SOEs was reduced by around half, with thousands of loss making concerns being restructured, sold or privatized with around 40 million workers losing their jobs.

Subsequently, the reform of the SOEs slowed. This reflected concern about the loss of jobs and the fact that the remaining businesses were not loss making, reducing the immediate need for restructuring. Over time, the state has reasserted its control over the economy with SOEs dominating critical sectors, such as banking, finance, transport, energy, natural resources and heavy industry.

Large scale privatizations, mooted by foreign observers, are unlikely. New reform initiatives focus increasing dividend payouts to boost government revenues and on the State acting as a patient, long-term investor maximising the value of its holdings.

Unsurprisingly, the SOEs oppose any

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change. The economic and political power of large SOEs and their leaders, many of whom hold ministerial rank, may thwart reform. For example, removal of subsidies by the central government frequently results in provincial governments increasing these to maintain the business. For example, the bankrupt solar panel maker Suntech was bailed out by Wuxi's city government.

Confucius is reported as having stated: "*Only the wisest and stupidest of men never change*". For the moment, Chinese believe it is wise to maintain present strategy. History will judge their wisdom.

Part 1: Reforming China – Rebooting the Economic Engine added by **Satyajit Das** *on May 9, 2016*
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