A Proposal to Privatize Chinese Enterprises and End Financial Repression

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China's remarkable economic performance during the last two decades has rightly been hailed as an economic miracle. In this article, I briefly summarize the sources of the miracle, outline the serious problems China still faces because of the continuing financial repression necessitated by its unreformed and inefficient state-owned enterprises (SOEs), and provide a possible solution based on an efficient use of China's burgeoning foreign exchange resources.

China's Economic Miracle

The sources of the Chinese economic miracle are well known. The rise in rural incomes, with the adoption of the household responsibility system (the shift away from collectivized farming) and the bonus from the demographic transition with a fall in the dependency ratio (the ratio of children and the old to workers), led to a marked rise in savings rates. A monumental unintended consequence of the decollectivization of agriculture was the initiation of a boom in small-scale, nonfarm rural enterprises, which began with Deng Xiaoping's injunction that it was virtuous to be rich. Local party officials took this to heart, becoming directors and managers of township and village enterprises (TVEs).

With the rise in farm incomes, the pent-up demand for manufactured goods and housing was met by the TVEs, which were run as

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profit-making capitalist enterprises, even though they were collectively owned. They provided the local authorities with "extra-budgetary revenues" and gave officials legal opportunities to become rich. Unlike SOEs, the TVEs did not carry any welfare responsibilities and were free to hire and fire the abundant local labor. With Deng's creation of the Special Economic Zones in China's southern rim in the early 1980s, the TVEs—and later individually owned private firms—became the spearhead of a Dickensian capitalism.

These nonstate enterprises have made China into the processing center for manufactured goods in the world. Success has occurred by using cheap labor in the Chinese countryside along with foreign technology, and relying on self-financing from household savings and enterprise profits, along with foreign capital from the Chinese diaspora and a myriad of multinationals, and engaging in fierce locational competition promoted by local municipal authorities.[1] This labor-intensive industrialization is now spreading inland along the Yangtze (*The Economist* 2004: 13).

Total employment in TVEs, rose from 28 million in 1978 to 60 million in 1996. There was dramatic growth in individually owned enterprises. Their numbers rose from none in 1978 to 4 million in 1984, and 23 million in 1996, employing 76 million people. They have been the motor of China's spectacular labor-intensive industrialization. Angus Maddison (1998) estimates that real value added in this new small-scale sector rose by about 22 percent a year during the period 1978–94.

These spin-offs from the decollectivization of agriculture were aided by the massive buildup of infrastructure by the state. Labor-intensive export industries were further helped by domestic price reforms and by one of the largest unilateral liberalizations of foreign trade in history. Today most relative prices in China (unlike India) are closely aligned with world prices.[2] Chinese exports have exploded, growing eightfold between 1978 and 1995. By 2003 China was the world's third largest trading country, when its trade *increased* by more than $200 billion—twice the level of India's total trade in 2002. China's share of global trade is six times that of India's (Lardy 2003).

The rapid export-led industrialization in the private sector is based on processing imported components with domestic and foreign

[1]A major portion of the foreign investment in China consists of Chinese private capital recycled through Hong Kong. The importance of Hong Kong for the growth of nonstate enterprises in China lies in its efficient financial markets and legal system.

[2]For an earlier comparison of the similarities despite appearances in both the periods of economic repression and reform in the two Asian giants, see Lal (1995).

capital and technology, and cheap domestic labor. The private sector has grown so rapidly that its share in value added in the nonfarm business sector is nearly 60 percent (see Table 1), while its share of manufacturing output is now more than 70 percent compared with that of the moribund state sector, whose share has fallen from about 80 percent in 1978 to about 28 percent in 1998 (Lardy 2002: 15). This transition has led to spectacular growth rates of the Chinese economy during the last two decades: 9–10 percent per annum on official estimates, and 7–8 percent on independent estimates.[3] But the state sector still controls more than 70 percent of all fixed assets and 80 percent of all working capital in manufacturing.

TABLE 1
Value Added by Firm Ownership

	Value Added (%)		
	1998	2003	% Change
Nonfarm Business Sector			
Private sector	43.0	57.1	32.8
Public sector	57.0	42.9	–24.7
State controlled	40.5	34.1	–15.8
Collectively controlled	16.5	8.8	–46.7
Total (79 percent of GDP)	100.0	100.0	
Economy-wide			
Private sector	50.4	59.2	17.5
Public sector	49.6	40.8	–17.7
State controlled	36.9	33.7	–8.7
Collectively controlled	12.7	7.1	–44.1
Total (100 percent of GDP)	100.0	100.0	

Source: OECD (2005: 81).

This labor-intensive growth, based largely on private enterprise, has allowed the transfer of a vast amount of low-wage labor from both the rural sector and the declining state sector, and has enabled China to grow by "walking on two legs"—that is, keeping the SOE leg alive while expanding the nonstate sector. This strategy thus avoided the loss in output and employment and the attendant social disorder that

[3]There is a continuing dispute about measurement of Chinese growth rates (see Lardy 2002).

had characterized other transition economies in moving from the plan to the market.[4] But this strategy is now running into some serious obstacles which if not tackled could lead to the erosion of the Chinese miracle. The problems are all connected with the inefficient and unreformable SOEs.

Obstacles to China's Future Development

As its nonstate sector grew, China undertook a gradual reform of its state-owned industrial enterprises. Most were set up, as in India, under the unviable heavy-industry biased industrialization strategy. In the reform period, SOEs have been kept alive to avoid losses in output and employment, until the dynamic nonstate sector is large enough to absorb the labor their closure would release.

In the pre-reform period (before 1978) China's development strategy provided only limited urban employment opportunities. Consequently, the government assigned several workers to the same job, leading to a large labor redundancy in the SOEs. As these industrial workers only received a low wage to cover current consumption, the government also had to cover their pension, health, housing, and other social expenditures from the SOE revenues, which were mandated to be remitted to the government. In the reform period, the SOEs have been responsible not merely for wages but also for these "social" benefits, which has imposed a "social burden" on them that is absent in their non-SOE cousins. This burden has grown in the reform period as wages and benefits paid by the SOEs have grown by 16 percent per annum between 1978 and 1996, while their output grew by 7.6 percent per annum (see Lin 2004).

The SOEs' social burden is compounded by what Justin Lin calls the "strategic burden" arising from the growing unprofitability of these capital-intensive enterprises in an increasingly open market economy, as their lack of consonance with China's comparative

[4]China's task of moving from the plan to the market was much easier than that of the other socialist transition economies of Russia and Eastern Europe because of differences in their initial conditions. Russia and Eastern Europe had about 90 percent of their labor force in industrial SOEs, while most of China's labor force (80 percent) was in agriculture. For Russia and Eastern Europe the only route to a market economy was a "big bang" to dismantle SOEs, which resulted in short-term losses in output and employment. In contrast, China, by replacing its rural communes with the household responsibility system, all but in name restored privately run and owned family farms. This Chinese rural "big bang" led to a rise in output and allowed China time for gradual reform of its inefficient state-owned industrial enterprises.

advantage is revealed. So despite improvements in the management practices of SOEs, in their multifactor productivity (see Li 1997), and in their financial rates of return (see Table 2) most SOEs are unprofitable.[5] Lin (2004) estimates that even after the large implicit subsidies from low interest loans and other state subsidies, more than 40 percent of SOEs are currently operating at a loss.

TABLE 2
Financial Performance of Chinese Industrial Companies, 1999–2003

	Rates of Return (%)	
	State Controlled Firms	Private Controlled Firms
1999	5.4	8.8
2000	8.1	11.8
2001	7.2	11.9
2002	8.0	13.4
2003	10.2	15.0

Source: National Bureau of Statistics and OECD (2005: 3).

The Chinese government has tread warily in addressing the SOE problem because of concern over the social disorder that could be created by their wholesale closure. Between 1995 and 2002, employment in the state sector went from 109 million to 70 million, as a result of closing the most unprofitable SOEs.[6] The rest have been kept alive by subsidies through the banking system. The consequent debauching of the financial system and inefficient use of massive domestic savings poses serious problems for China's economic future.[7]

[5]The OECD (2005: 3) reports that the rise in SOEs' rates of return shown in Table 2 has come from a minority of companies: "Over 35 percent of all state-owned companies are not earning a positive rate of return and one in six has negative equity."

[6]The OECD (2005: 3) reports that in the 1990s "state-owned enterprises have been transformed into corporations with a formal legal business structure and many have been listed on the stock exchanges that were created in the early 1990s. Since 1998 a policy of letting small enterprises go and restructuring large companies has been successfully pursued, with the number of state-controlled industrial enterprises falling by more than half during the following five years. Employment contracts were made more flexible, leading to job reductions in the industrial sector of more than 14 million in the five years to 2003. This process was aided by the creation of unemployment and welfare programs that transferred the burden of compensating redundant workers from enterprises to the state."

[7]The Congressional Research Service (2005: 10) noted in its brief to Congress on Chinese economic conditions that "currently, over 50 percent of state-owned bank loans now go to the SOEs, even though a large share of loans are not likely to be repaid."

The drag that SOEs still exert on Chinese economic performance can be best illustrated by contrasting savings rates in India and China and by the economic growth these have yielded. The Chinese savings rate of about 40 percent is about twice that of India, yet its growth rate is only 2–3 percentage points higher than India's, implying incremental capital-output ratios of 5.3 for China and 3.8 for India.[8] The reason is that nearly 90 percent of Chinese household savings are placed in the state-owned banks, which channel them at subsidized rates to the low return and often loss-making SOEs. The efficient private sector is crowded out of access to the bulk of Chinese savings, and the overall growth rate is then brought down by the low returns in the state sector. This continuing subsidization of the SOEs to meet the social burdens imposed by the past development strategy, based on promoting heavy industry through planning, is leading to serious problems of economic management and inefficiencies in the allocation of investment.

China's adherence to an outdated development strategy—not in line with the comparative advantage of a labor abundant and capital-poor developing country—has resulted in financial repression, whereby the government has to monopolize the mobilization and deployment of savings in the economy, along with stringent import controls (see Lin 2003, Lal [1983] 2002). This strategy allows the artificial lowering of the relative price of the economy's scarce capital to make capital-intensive enterprises viable. Thus, in China today, nearly 90 percent of household savings are still held in deposits with the state-owned banks, in part because of the lack of alternative savings instruments. Alternatives like investing in stocks of fast growing nonstate firms are obviously discouraged because that would divert funds from politically favored SOEs. Indeed, most bank deposits are loaned (directly or indirectly) to SOEs while most of the investment in the nonstate sector is either self-financed or dependent on foreign capital.[9] With few privately owned growth enterprises being

[8]These figures have been derived from Maddison (2003: 174, 184), who gives the growth rate of GDP in 1990 PPP $ of 7.5 percent per annum for China and 6.1 percent for India in 1991–2001, and an investment rate of 40 percent for China and 23.3 percent for India in 1999.

[9]Huang (2003) finds that overseas Chinese capital has been an important means though which the non-state enterprises have overcome the distortions in China's capital markets. By contrast, the direct investment by foreign multinationals has gone mainly to SOEs. Much of this capital has been misappropriated. The multinationals retain ownership of nearly all technology. They also provide the marketing outlet for most of the industrial exports from the non-SOEs, which have become processing centers of multinational firms. For an enthralling account of how multinational investments to modernize state enterprises have failed, see Crissold (2004).

willing or allowed to issue stocks, the stocks traded on the domestic stock exchanges are mainly those in the SOEs, whose nontransparent accounting practices and perceived unviability deters households from investing much of their savings in those stocks. Hence, domestic stock markets are thin and volatile.

Many of the supposedly large private enterprises have an ownership structure that is at best opaque and are likely to be state controlled (see *The Economist* 2005: 60). The truly private enterprises, which are the descendants of the TVEs, do not list on the domestic stock market and depend more on self-financing and direct investment by the Chinese diaspora for their capital requirements (see Tables 3 and 4).

TABLE 3

FINANCING OF PRIVATE ENTERPRISE IN CHINA, 1999

	Percentage of Surveyed Firms:			
Years in Operation	Self-Financed	Bank Loans	Nonfinancial Institutions	Other
<3 years	92.4	2.7	2.2	2.7
3–5 years	92.1	3.5	0	4.4
6–10 years	89.0	6.3	1.5	3.2
>10 years	83.1	5.7	9.9	1.3

SOURCE: Based on a 1999 survey of more than 600 private Chinese enterprises in Beijing, Chengdu (Sichuan), Shunde (Guangdong), and Wenzhou (Zhejiang) by the International Finance Corporation (Gregory, Tenev, and Wagle 2000).

TABLE 4

SHORT-TERM LOANS OF FINANCIAL INSTITUTIONS (AS PERCENTAGE OF TOTAL SHORT-TERM LOANS)

Use of Funds	2002	2003
Loans to township enterprises	9.18	9.16
Loans to private enterprises and individuals	1.43	1.75
Loans to Sino-foreign joint venture and co-operative enterprises and foreign-funded enterprises	3.63	3.07
Total	14.24	13.98

SOURCE: Derived from *Statistical Yearbook of China* (2003, 2004).

The lack of adequate savings vehicles, and the low return households currently get from their savings in the state-owned banks, poses a future threat to the maintenance of China's high savings rate, particularly when account is taken of the natural depressant of savings with the projected rise in the dependency ratio with the aging of the population from about 2010. But the state-owned banks cannot promote higher savings by raising their deposit rates without a rise in their lending rates to the unviable SOEs whose losses would increase, leading the banks to further increase their loans to cover these losses and thus to a further increase in the nonperforming loans in the banking system.

These microeconomic difficulties in using the interest rate to stimulate savings and for the efficient sifting and deployment of investments are further compounded by the macroeconomic consequences of financial repression. Because the interest rate cannot be used as an instrument for managing aggregate demand, heavy-handed administrative measures with all their inherent inefficiencies and limited effectiveness (given the self-financing of most private investment) are needed to cool the economy. Furthermore, given the fragility of the banking system, fully opening up the capital account of the balance of payments followed by a move to a fully flexible exchange rate system is ruled out as it could lead to a serious financial crisis.

Unlike many observers, I do not think that China's export-led growth has depended on maintaining an undervalued exchange rate, because most of Chinese manufactured exports are processed goods with little domestic value added.[10] Changes in the exchange rate would not markedly affect their profitability. A flexible exchange rate would not therefore harm China's phenomenal export-led growth. Rather, it would allow for a more efficient use of China's national savings and fend off the growing pressures for a revaluation of the yuan from both private speculators and China's major trading partners, which have been mitigated but not removed by the recent move to a managed float of the yuan against a basket of currencies, and by the modest revaluation that has occurred.

Behind all these prospective dangers currently facing the Chinese economy lie the policy and social burdens carried by the SOEs because of China's past development strategy. The answer must be to eliminate these burdens so that the viable SOEs can be privatized and prosper in a globally integrated market economy, or are shut down

[10]This is estimated to be about 20 percent of the value of the output.

without causing domestic disorder. Fortunately, China's large accumulation of foreign exchange reserves provides the means to do so.

Using Foreign Exchange Reserves to Help End Financial Repression

The Chinese government does seem to be using its foreign exchange reserves to deal with its SOE problem, but in a way that it likely to be highly wasteful. It is using these reserves as part of its strategy to create "globally competitive multinationals" from its best state firms, mainly in the natural resources sector, as well as some in some consumer goods and high tech industries where it hopes they will become global brands. The recent binge by Chinese SOEs into big foreign acquisitions, however, seems of dubious economic value. Most natural resources, like oil and iron ore, are now internationally traded bulk commodities. The true opportunity cost of the domestic use of these resources remains the fluctuating world price determined by global demand and supply. It is illogical to assume that just because one owns a foreign iron ore mine or oil deposits the cost of using those assets in the home country will be lower than the world price at which they can be imported. Moreover, acquiring foreign assets does not guarantee that such acquisitions create any greater security of supply than that provided by forward contracts in the world markets for these commodities—unless the Chinese are aiming to enforce their property rights in owning these foreign assets by military might against any attempt at expropriation by local nationalist predatory elites. Also, it is unlikely that the rate of return of these state enterprises will be higher if they operate abroad rather than at home for the well-known reason concerning incentives and soft budget constraints of public enterprises.[11]

It is also doubtful that China will be able to create world-class companies in consumer goods and high-tech industries out of SOEs.[12] The problem remains that SOEs (however the extent of state control is disguised) retain the well-known problems of sclerotic management and inefficiencies arising from soft budget constraints. From

[11]India too is making a similar mistake in using its own large buildup of foreign reserves to go on a global buying spree of foreign natural resource assets.

[12]*The Economist* (2005: 61) noted that looking back at the first crop of potential champions a decade ago, most have collapsed. For example, "D'Long, a conglomerate spanning food and financial services, was lauded as a smart operator that bought tired foreign brands for a song and cut costs by taking manufacturing to China—until last year when it collapsed with huge debts."

worldwide experience the only solution for SOEs is privatization. Using the foreign exchange reserves to enable these SOEs to acquire foreign assets is only to throw good money after bad. A better use of these reserves would be to deploy them to enable the privatization of the remaining SOEs without causing social disorder.

China's foreign exchange reserves now stand at $875 billion, which in a roughly $2 trillion economy means they are about 44 percent of Chinese GDP. At the moment they are largely held in the form of U.S. Treasury securities. Apart from the absurdity of a relatively capital-poor developing country making these large unrequited capital transfers to a capital-rich country, China must have seen a loss in the real value of these assets. For since its peak in 2002 the U.S. dollar has depreciated by more than 30 percent in trade-weighted terms against the major currencies, while in 2003 the Citigroup U.S. Treasury Index returned a modest 2.3 percent. The return on China's foreign exchange reserves (in trade-weighted terms) is likely to have been negative over the last few years. A small part of these reserves has been put into Chinese foreign investments abroad, ($2.9 billion in 2003, but now likely to grow with China's recent race to acquire foreign natural resource assets). Those investments, however, are unlikely to yield large returns.

There is a much better way to deploy China's foreign exchange reserves. Only a small part—say $100 billion—are needed to fend off any speculative attack on the yuan and to maintain the chosen shifting peg to the basket of currencies under China's managed float. The other $775 billion, as well as any future accruals, could be put into a Social Reconstruction Fund (SRF) under the supervision of the People's Bank of China (PBC), the central bank. This fund would be run like many public pension funds that are overseen by a committee that decides the broad sectoral distribution of the fund and the target rate of return (keeping the value of its capital intact), which it expects the fund's mangers to beat.

For example, the World Bank's pension fund is valued at just over $10 billion, and the asset allocation laid down by the Bank's management is U.S. equities 19 percent, non-U.S. equities 16 percent, hedge funds up to 12 percent, private equity up to 12 percent, real estate up to 8 percent, and fixed income securities 40 percent. In 2003 the fund's return was 18.4 percent, and over a 10-year period the return was about 8 percent. There is no reason why the SRF should not be able to do as well, provided the day-to-day management is done by a reputable team drawn from around the world and held accountable to the PBC. Thus, we could expect the SRF to yield about $62 billion annually from the proposed fund of $775 billion. But, even if we are pessimistic and assume that it only achieves an average long-term return of 5 percent per annum (while keeping capital intact) that should yield at least $39 billion per annum. Thus, the SRF could earn 2–3 percent of current Chinese GDP as income each year.

This annual income from the SRF should initially be used to retire the existing social burdens carried by the SOEs. They could then be treated as normal commercial enterprises that could be privatized if viable or closed down if not. This reform would end the subsidies from the banking system that have led to its fragility, allow transparent accounting of privatized SOE stocks traded on the stock market, allow the banks to perform their primary intermediating function of efficiently mobilizing domestic savings and transferring them to high-yielding investment projects, and allow China to float the yuan. In time, as the SOE problem disappears, the income from the SRF could become the basis for a fully funded pension system for China's increasingly aging population.[13]

Conclusion

The SRF thus provides a means for China to move fully from the plan to the market by removing the sources of fragility in its financial system, while removing any danger of social disorder from the rescinding of the current social burdens borne by the SOEs or from the future need to provide pensions for an aging population.

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[13]Today only about 14 percent of China's active population is covered by the pension system. The 1997 reform created a two-tier system, with a flat rate under the first tier and a proportional rate based on one's contributions under the second part. This second tier could be the basis for creating fully funded personal accounts, with the funds invested in domestic and foreign capital markets. China has also committed to using part of the proceeds from the sale of SOEs to help fund individual accounts (OECD 2005: 1).

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