

Chapter 3

Shifting the Pattern of Chinese Growth

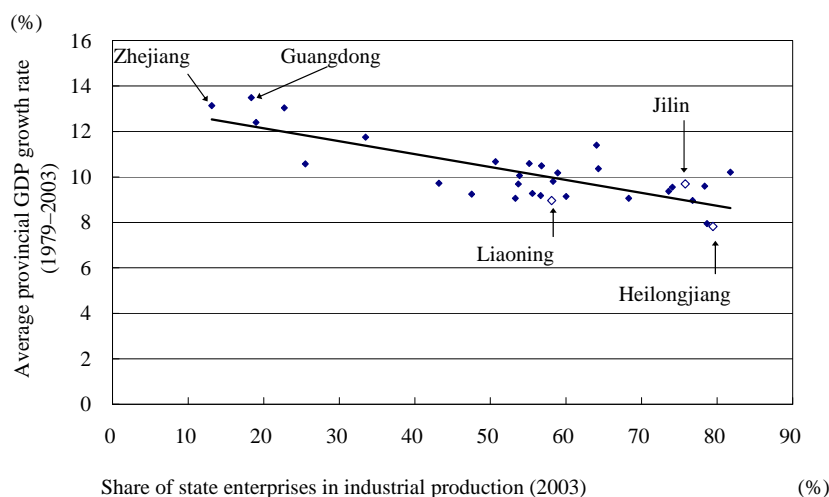
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Key Points

- China's rapid growth since the launch of reform and opening up has relied on expansion of investment, labor, and other inputs; production efficiency has not been especially high. As indicated by worsening environmental problems, rising wages, and steeply climbing prices for energy and other primary products, input constraints have now emerged. Doubts about the sustainability of high growth are being expressed.
- In view of the need to shift the growth pattern from expansion of inputs (extensive growth) to improvement of productivity (intensive growth), the 11th five-year plan (2006–10) places emphasis on improving the efficiency of resource utilization, boosting sustainable development, enhancing independent innovative capability, and upgrading the industrial structure.
- The fundamental reason for the long period of extensive growth is the lingering negative effects of the old system. In order to execute a shift to intensive growth, state-owned enterprises must be privatized, and the institutions of the market economy must be fully developed. The key to this shift will be clearing away the impediments to privatization, including the old ideology espousing retention of public ownership and the monopolistic position of state enterprises in core industries.

Key Data: Provincial GDP Growth Rates and Shares of State Enterprises



Source: Prepared from annual editions of the *China Statistical Yearbook*

1. Emerging Constraints on Growth

As the Chinese economy has developed into its vast current state, constraints on growth have emerged in areas like resources, the environment, and availability of labor. As the population begins to age, moreover, the high savings rate that sustained aggressive investment is expected to decline. In order to keep growth moving at a fast pace, China must increase its resource and investment efficiency.

1.1 Resource and environmental constraints

China has entered the stage of industrialization (including development of heavy and chemical industries) and urbanization, and its importance as a processing base for the world has increased, assisted by the arrival of multinational corporations. China's demand for resources is growing rapidly, partly because the nation's enterprises utilize resources relatively inefficiently. Although its gross domestic product (measured with nominal exchange rates) accounts for only 5.5% of global GDP, China consumes much larger shares of key resources, including 15% of global energy (1,240 million tons standard carbon equivalent), 30% of steel (388 million tons), and 54% of cement (1,240 million tons) (according to a speech by Ma Kai, then minister of the National Development and Reform Committee, on March 18, 2007, at the Eighth High-Level Forum on Chinese Development). China has no choice but to rely on imports for a substantial portion of its resource needs, and international primary product prices are moving sharply upward as a result.

Against a backdrop of rapid industrialization and motorization, China has moved ahead of Japan to become the world's second-largest consumer of oil. With domestic demand expanding, oil exports have declined and imports have rapidly increased. In 1993 the country shifted from being a net exporter to a net importer of oil, and since then the gap between imports and exports has grown wider and wider. As of 2006 China's imports of crude oil and petroleum products amounted to 191,560 thousand tons (\$82.0 billion), and its oil trade deficit was \$72.2 billion (2.7% of GDP).

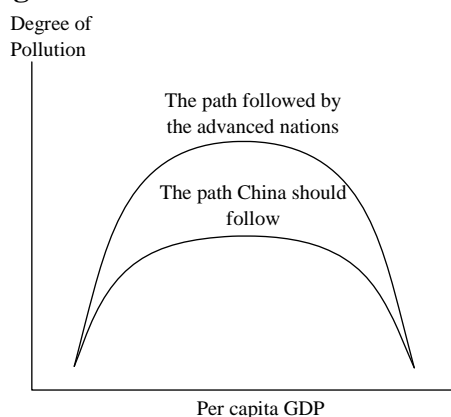
Rising oil prices affect the Chinese economy through the following three channels. First, in the case of companies engaged in production in China, higher oil prices drive up production costs. Product prices rise, while production declines. The same influence is also felt in advanced industrialized countries, which are China's main export markets, and as this causes the world economy to decelerate, Chinese exports slow down, causing production to fall further. Furthermore, higher oil prices imply a deterioration in China's terms of trade (the relative prices of a country's exports to imports), and to that extent there is a decrease in the purchasing power of Chinese national income. If China's net oil imports amount to \$70 billion per year, a 10% hike in oil prices will add \$7 billion to import payments. This is an income transfer from China to oil-exporting

countries, and it falls on the shoulders of the people in the form of reduced corporate earnings and higher consumer prices.

Being in the initial stage of industrialization, when mass consumption and wastage of resources cause serious harm to the environment, China is under pressure to come up with full-fledged environmental measures (see the box). It is suffering in particular from worsening pollution in the form of solid wastes, automotive exhaust gases, and residual organic pollutants. According to the “China Green National Accounting Study Report 2004,” issued jointly by the State Environmental Protection Administration and the National Bureau of Statistics in September 2006, air and water pollution and other forms of environmental damage caused economic losses amounting for at least 3% of GDP. If this estimate is on target, China’s green GDP growth rate was 3% or more below its real growth rate in 2004. When we take into account the huge size of the country, which has more than a 20% share of the world’s population, we can appreciate that environmental degradation within China is by no means just a domestic concern. Its impact reaches into neighboring countries and out across the whole world in such forms as global warming and acid rain. Moreover, because Chinese companies are not shouldering heavy environmental costs, enabling them to export products relatively inexpensively, they are provoking increasingly strident complaints from abroad of “environmental dumping.”

Box.**Relationship Between the Environment and Economic Growth**

It can be observed from the experience of Japan and many other countries that the environment deteriorates in the initial phase of economic growth and then turns for the better after a certain level of development is achieved. When this relationship is charted in a graph measuring the degree of environmental contamination against per capita GDP, the result is an inverted *U* curve (called an environmental Kuznets curve) (see figure). Among the factors that act to reverse the decline in environmental quality are changes in industrial structure (growing weight of the service sector), technological development, and the implementation of environmental protection measures as the public's awareness rises.

Figure. Environmental Kuznets Curve

Source: Prepared by the author.

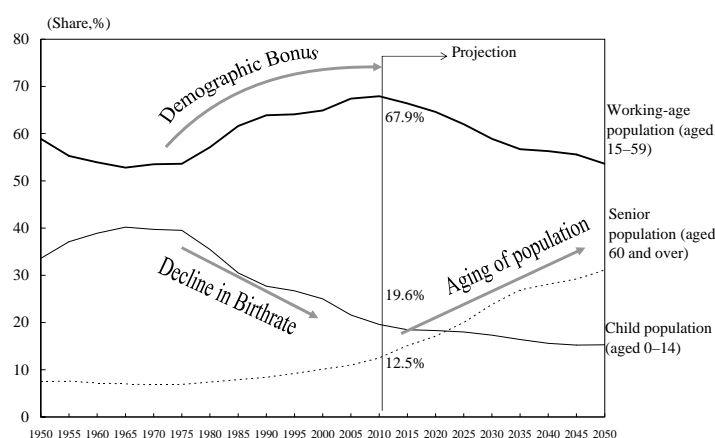
Encouraged by the “success stories” of Japan and other countries, China has given priority to economic growth, even if it comes at a high cost to the environment. This strategy has now reached its limit, however, because of the grave environmental problems the country has encountered, as well as their worldwide impact. If we see the Kuznets curve as a mountain, we can say that China's need is to dig a tunnel through it. And in this endeavor, it needs to make use of the experience and technologies of the advanced countries.

From this perspective, speaking at the sixth national environmental protection conference on April 17, 2006, Chinese Premier Wen Jiabao called for a shift in direction in three respects: (1) from placing emphasis on economic development and disregarding environmental protection to placing emphasis on both, (2) from considering environmental protection as an issue to be addressed after the economy develops to moving forward simultaneously on both environmental protection and economic development, and (3) from using primarily administrative means to protect the environment to resolving environmental problems through the combined application of legal, economic, technological, and any necessary administrative means.

1.2 Labor constraints

In order to suppress population growth, China introduced a planned birth policy in the first half of the 1970s, and as part of this effort, it began to enforce a one-child policy early in the 1980s. In a relatively short period of time, with the help of a decline in infant mortality and an increase in average life expectancy, China executed a demographic shift from the developing-country pattern of high birth rates, high death rates, and fast population growth to the developed-country pattern of low birth rates, low death rates, and slow population growth (figure 1).

Figure 1. Change in Population by Age in China



Source: United Nations, *World Population Prospects: The 2006 Revision*.

Note: Projection by the United Nations.

During this transition, the decline in the birthrate occurred before the graying of the population, and a “demographic bonus” that worked to enhance economic growth was generated by a rise in the share of the working-age population and a decline in the ratio of dependents. Now, however, the aging of the population is starting to bite, and it will be accompanied by a reduction in the share of the working-age population and an increase in the ratio of dependents. Population aging is a phenomenon commonly seen in developed countries, but China will have to endure the severe trials of the process at a stage where the country is not yet that affluent.

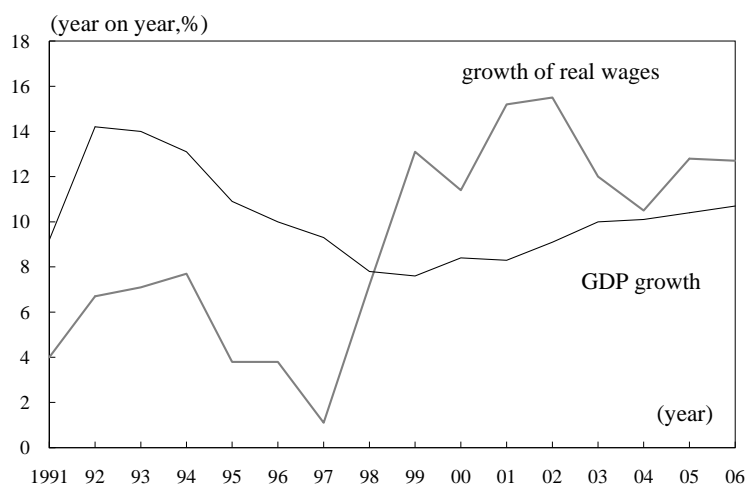
With the introduction of the planned birth policy, the Chinese birthrate dropped from 3.69% in the second half of the 1960s to 1.36% in the first half of the 2000s, while the population growth rate dropped from 2.61% to 0.67%. This not only suppressed population size but also radically altered the demographic structure. If we use a threefold classification of children aged 0–14, working-age people aged 15–59, and seniors aged 60 and over, we find that the share of children in the population fell from 35.5% in 1980 to 21.6% in 2005, while the share of senior citizens rose from 7.4% to 11.0%. With the decline in the share of children outpacing the rise in the share of the elderly, the share of the working-age population increased from 57.1% to 67.4%.

The graying of Chinese society will now pick up speed, however. According to a United Nations projection, the population share of those aged 60 and over will reach 17.1% in 2020 and 23.8% in 2030. In the meantime, as the downward trend in the share of children levels off, the rise in the share of the working-age population will peak in around 2010 (at 67.9%) and then decline. In addition, while it is predicted that the overall Chinese population will begin to contract around 2030, the working-age population will begin to contract well ahead of that, with a predicted turning point coming around 2015. Reflecting the decrease in the number of children and the increase in the number of elderly, the population's median age is expected to rise from 22.1 years in 1980 and 32.5 years in 2005 to 41.3 years in 2030.

The one-child policy is expected to have some negative effects in the years to come, notably slower growth of the labor population and a lower savings rate. In particular, China is likely to reach the end of its high-growth period, which has been underway since the end of the 1970s, when the positive effect of the demographic bonus fades away around 2015. In this light, the next 10 years may represent China's final chance to devote itself fully to becoming an advanced country.

At the same time, there is still a sizable pool of surplus labor in rural areas. Because of this, some say, the aging of the population will not immediately cause a labor shortage, and the labor supply will not be a constraint on growth. However, as can be appreciated from the fact that the supply of migrant workers has recently become tight in coastal regions, China is moving quickly toward the stage where a labor surplus reverses to a shortage.¹ Reflecting this change, the relationship between real wage growth and GDP growth has reversed. Whereas the former remained well below the latter until 1998, real wages are now moving up faster than the economy is growing (figure 2).

¹ It is often claimed that China's agricultural sector has a labor surplus on the order of 150 million workers. This figure was recently cited in the government's January 2007 Research Report on National Population Development Strategy. But Director Cai Fang of the Institute of Population and Labor Economics of the Chinese Academy of Social Sciences has drawn notice for a series of studies painting a different picture. He believes that the turning point (known as the "Lewisian turning point") when the surplus labor pool disappears and shortages become widespread may arrive as early as 2009. (See "The Transition Facing the Chinese Economy and Its Challenge to Development and Reform" (in Chinese), *Zhongguo shehui kexue* (Social Sciences in China), no. 3, 2007, and "Employment Expansion and Structural Change in China" (in Chinese), report at the Chinese Academy of Social Sciences, May 10, 2007). Cai argues that in a context of fast economic growth and declining growth of the working-age population, which has been influenced by the full-fledged implementation of the one-child policy since the early 1980s, growth of labor demand has exceeded growth of the labor force ever since 2004, and the surplus labor in the rural sector will completely dry up around 2009.

Figure 2. The GDP Growth Rate and Real Wage Growth Rate

Source: *China Statistical Abstract 2007*.

The shift of rural China's surplus labor into the industrial sector supported the nation's high-speed growth in a number of ways. First, on the supply side, the absorption by the industrial sector of idle workers in the agricultural sector made a direct contribution to GDP expansion. Next, the ability of the nation to keep wages at a low level worked to the advantage of the high-income group, which receives proceeds from capital income in the distribution of income, and this led to high savings and high investment. On the demand side, meanwhile, low wages facilitated a pattern of export-led growth based on low costs. When full employment is reached, however, wages begin to rise in step with productivity increases, and employment becomes subject to the constraint of the growth rate of the labor population. At that point, the competitiveness of exports from labor-intensive industries begins to decrease. In this light, the drying up of surplus labor in rural areas is expected to work alongside the graying of Chinese society as a factor depressing the potential growth rate.

1.3 Room for improvement in investment efficiency

Brisk investment has worked together with abundant labor supply to support fast-paced growth. The efficiency of Chinese investment is not that high, however, so there is ample room for improvement.

The low level of China's investment efficiency can be ascertained from an international comparison of capital coefficients (table 1). The capital coefficient is calculated by dividing the investment ratio by the real growth rate, and smaller coefficients denote better efficiency. Over the 2001–06 period China's ratio of investment to GDP was 40.7% while its growth rate was 9.8%, resulting in a capital coefficient of 4.2 ($40.7 \div 9.8$). In other words, investment corresponding to 4.2% of GDP was required to lift the growth rate by 1 percentage point. In the 1960s Japan's economy was breezing along at a 10.2% pace, somewhat faster than the Chinese

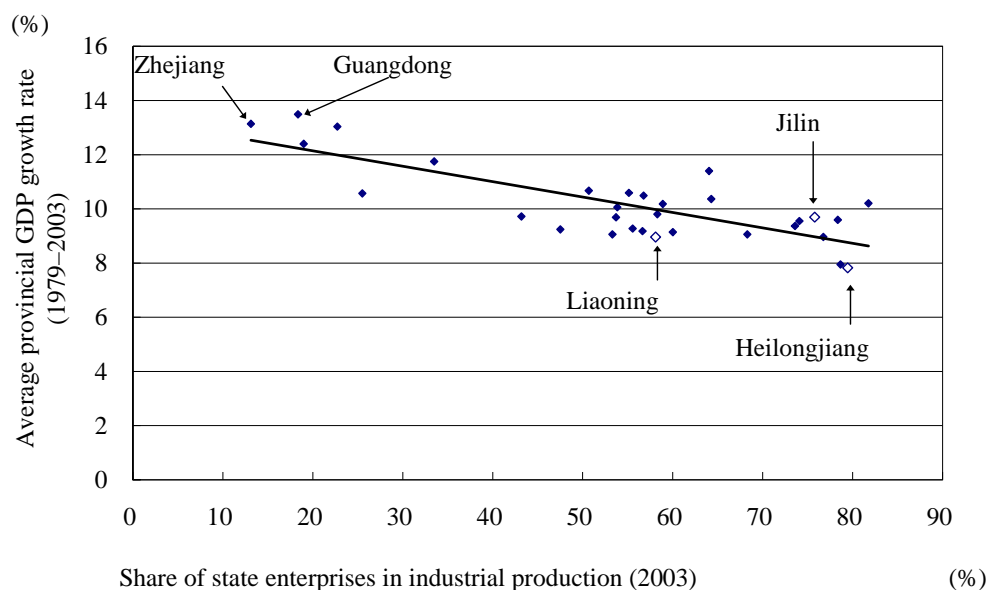
economy has recently been moving, but Japan's investment ratio was only 32.6%, and this produced a lower capital coefficient of 3.2. During the high-growth period of South Korea and Taiwan in the 1980s, similarly, each had a capital coefficient considerably lower than China's, 3.2 for South Korea and 2.7 for Taiwan.

Table 1. Comparison of High-Growth-Period Capital Coefficients in China, Japan, South Korea, and Taiwan

	Investment ratio (share of GDP, %) a	Growth rate (%) b	Capital coefficient a/b
China	91-95	39.0	3.2
	96-00	36.6	4.3
	01-06	40.7	4.2
	(1991-2006)	38.9	10.2
Japan (1961-1970)	32.6	10.2	3.2
South Korea (1981-1990)	29.6	9.2	3.2
Taiwan (1981-1990)	21.9	8.0	2.7

Sources: Prepared from official statistics of each country.

The fundamental cause of the poor efficiency of the Chinese economy is the fact that state-owned enterprises still have a weighty presence, particularly when measured on the input side. It is common in all countries for state-owned companies to be operated inefficiently, and China is no exception. In fact, ever since China embarked on the path of reform and opening up, the pace of growth has been lowest in the regions with the highest share of state enterprises (figure 3). For example, the three northeastern provinces of Heilongjiang, Jilin, and Liaoning, which have a higher share of state enterprises than other provinces, have recorded growth rates that are lower than the national average. The country's highest growth rates have been achieved in Guangdong, where many foreign companies have moved in, and in Zhejiang, where private companies are active.

Figure 3. Provincial GDP Growth Rates and Shares of State Enterprises

Source: Prepared from annual editions of the *China Statistical Yearbook*.

Even in a developed capitalist economy, separation of a company's ownership and management creates a risk of harm to owners' profits from management. As can be seen in the recent talk about the "absence of owners," this has developed into a critical problem in China's state enterprises, whose ownership is ambiguous. To be sure, it can be said that all the individuals in the Chinese population of 1.3 billion are the ultimate owners of all state enterprises, giving each a 1.3-billionth ownership right. But none has the ability or incentive to supervise these companies, which number in the hundreds of thousands, and even if they did, there would be no way to hold a meeting of all the shareholders. In this situation, the people have no choice but to entrust their rights as shareholders of state companies to public organs, which act as their representatives. The government, however, does not pursue the sole objective of maximizing profits in its management of state-owned assets. It has a variety of goals, including generating employment, maintaining social stability, and guaranteeing equality of opportunity. In addition, the government officials who formulate and implement policies put their own interests ahead of the interests of the people and the nation. In the end, we arrive at the question of who manages the managers. This is a difficult question to answer even in developed countries that have a fully functioning system of democracy with elections and legislatures, and it is all the harder to answer in China, which has adopted as its political system a one-party dictatorship, an arrangement poorly suited to public oversight.

Complicating the situation, extensive government interference in the financial system means that the mechanism for turning people's savings into investment is not operating effectively. In the area of indirect investment, the big four state-owned commercial banks, which play a pivotal role in the banking sector, resemble the state enterprises that receive much of their financing in that they have not established adequate corporate governance structures and are not managed so as to maximize profits for the Chinese people, who theoretically are their shareholders. Because they have set low interest rates on loans to state companies in order to help them survive, they are not fulfilling their role of channeling resources into projects with the highest rates of return. In addition, when loans they have extended turn into bad debts, they rarely force the parties concerned to take responsibility. On top of that, these state-owned commercial banks suffer heavy interference from public officials, particularly local authorities, in matters concerning personnel, financing, and other management matters. Small wonder that nonperforming assets are steadily building up.

In the area of direct finance, securities markets play the primary role, but they have fallen into a dysfunctional state. China's conventional stock market was distinguished by its dual structure of both tradable and nontradable shares. Approximately 70% of all the shares were effectively out of circulation. While holders of nontradable shares (government organs and state enterprises) are more interested in net asset expansion through offering new shares than rising share prices, as minority shareholders, holders of tradable shares could not influence the behavior of the management teams named by the major holders of nontradable shares. As a result, the stock market had a strong speculative character, so much so that some economists called it a "casino," and it was unable to function effectively as a place to raise and invest funds and discipline managers' behavior.

1.4 Savings rate expected to decline

Even though investment efficiency is poor, China has been able to zoom forward at annual growth rates on the order of 10%. To a large extent, this has been possible thanks to investment expansion. China's ratio of investment to GDP is already high compared to those of other countries—and it is rising. What has enabled such a high investment ratio is the high savings rate. The savings of the Chinese people provide the main source of investment funds, and China's savings-to-GDP ratio is exceptionally high, both in international and historical terms.

Among the factors that have pushed the savings rate up are the relatively young demographic structure, faster than anticipated growth rates, widening income disparities, constraints on consumption resulting from the inadequacy of the financial system, the absence of social security systems, and high savings in the corporate sector in a context of high profits. These factors will be changing greatly in the years to come, however, and it is expected that the savings rate will decline over the long term.

First, the bill for the one-child policy will soon fall due in the form of a decline in the share of the working-age population starting from 2010. The full-fledged aging of the Chinese population will then begin.

Second, on top of this aging, the labor surplus in rural areas will disappear, and as China approaches the advanced-country stage of development, its advantages as a latecomer to development will diminish. The pace of growth should therefore slow down.

Third, the Chinese government is aiming to build a “harmonious society” for the sake of social stability and to retain its own hold on power, and a precondition for this will be correcting income disparities.

Fourth, as symbolized by the moves of the major state-owned banks to secure listings on stock markets abroad, financial reform is progressing at a furious pace. Over the years to come, we can expect the constraints on liquidity that have hampered consumers to gradually loosen.

Fifth, work on the construction of pension and other social security systems is progressing, although many tasks remain to be tackled.

Finally, public opinion is swinging behind the idea that state enterprises should pay dividends to the state, which provides them with capital, and thereby return profits to the people. The government is now considering concrete measures to bring this about.

If for such reasons it becomes difficult to sustain savings at a high level, the nation should promptly execute a shift in growth pattern so as to keep the economy moving rapidly. The “extensive growth” path followed so far, which is based on securing ever-larger volumes of inputs, must be switched to “intensive growth” achieved by increasing productivity.

2. Measures to Realize a Shift in the Growth Pattern

Now that the limits of growth based on input expansion have become evident, the Chinese government is seeking to change the growth pattern. In its 11th five-year plan, which began in 2006, the government laid stress on such policy tasks as improving the efficiency of resource utilization, boosting sustainable development, enhancing independent innovative capability, and upgrading the industrial structure. The pattern of extensive growth has persisted nonetheless, and the chief reason is the lingering negative effects of the old system. Efforts must therefore be made on a number of fronts,

such as privatization of state enterprises. For the sake of enhancing efficiency, the institutions of the market economy must be fully developed.

2.1 Priority tasks in the 11th five-year plan

Regarding measures to assist a change in the growth pattern, China's 11th five-year plan stresses the importance of improving the efficiency of resource utilization, boosting sustainable development, enhancing independent innovative capability, and upgrading the industrial structure.

The plan has the following aims for improving the efficiency of resource use and promoting sustainable development: "Making resource conservation a basic national policy, we will develop a recycling economy, protect ecology and the environment, and hasten to build a society that conserves resources and is friendly to the environment, striving to harmonize economic development with human beings, resources, and the environment. We should promote informationalization of the national economy and society, tread firmly along the path of a new type of industrialization, stick to development that is economical, green (environmentally friendly), and safe, and realize sustainable development." The reference here to a "recycling economy" points to an economic growth model centered on the recycling and reuse of resources, with low consumption of raw materials, low discharge of pollutants, and high efficiency. In concrete terms, making environmental protection and resource conservation primary targets, China will seek to reduce energy consumption per unit of GDP by 20% within five years, cut the discharge of major pollutants by 10%; and increase forest coverage from 18.2% to 20% (table 2).

Table 2. Main Population, Resource, and Environmental Targets of the 11th Five-Year Plan, 2006–10

	2005 results	2010	Annual average(cumulative totals in brackets)
Population	1.30756 billion	1.36000 billion	under 0.8%
Energy consumption per unit of GDP			[down 20%]
Water consumption per unit of industrial production			[down 30%]
Coefficient of effective use of irrigation water	0.45	0.5	[0.05]
Rate of comprehensive use of solid industrial waste	55.8%	60%	[4.2%]
Cultivated land area	122 million hectares	120 million hectares	-0.3%
Total discharge of major pollutants			[down 10%]
Forest coverage	18.2%	20%	[1.8%]

Source: "Main Targets of the 11th Five-Year Plan for National Economic and Social Development," March 2006.

Note: GDP and per capita income of urban and rural residents based on 2005 prices; the main pollutants are sulfur dioxide (SO₂) and chemical oxygen demand (COD).

Furthermore, the plan aims “to implement thoroughly a national advancement strategy in science, technology, and education and a human-resources-for-a-strong-nation strategy (a strategy to make the nation strong by means of talented human resources). We will place the enhancement of independent innovative capability at the center of industrial structure adjustment and growth pattern redirection as the base of the science and technology development strategy, striving to enhance basic research ability, product and technological development ability, and the ability to introduce, absorb, and improve.” To this end, the plan sets the target of raising the ratio of research and development spending to GDP from 1.3% in 2005 to 2% within five years. In the process, it is hoped that China will see the emergence of a profusion of companies that have their own intellectual property rights and famous brands and that possess strong international competitiveness.

As for the orientation to be pursued in upgrading the industrial structure, China will promote the development of the service sector, which requires fewer inputs of resources than the industrial sector. Among the industries to be promoted are information, finance, insurance, distribution, tourism, and community services. The targets are an increase in the service sector’s share of GDP by 3 percentage points and its share of employment by 4 percentage points.

2.2 Deeper market reform: A precondition for success

The goal of changing from an extensive to an intensive mode of economic growth is one that was set earlier in the 9th five-year plan (1996–2000), but it has unfortunately not been realized yet. In 2006, the first year of the 11th five-year plan, energy consumption per unit of GDP was reduced 1.23%, but at this pace, the goal of a 20% reduction over five years will not be met. The idea of shifting the pattern of economic growth is one that people favor in principle but object to when it comes to particulars, since China is still shouldering the negative legacy of the old system. To rid itself of this load, the nation must part ways with the old system and fully embrace the institutions of the market economy. In particular, reform in the following areas is needed.

First, systems should be set up to impose costs on resource users commensurate with their level of consumption. For instance, if an environmental tax proportional to the amount of pollutants released were introduced, companies and consumers discharging pollutants would be forced to pay as “private costs” what had been the “social costs” of the pollution, which would work to curb the release of pollutants. In addition, the pricing of resources needs to be reconsidered. Because many such prices have been kept artificially low, it has been more profitable to use large quantities of resources than to invest in resource-saving production facilities. In this way, inexpensive resources can be seen as an impediment to a shift in the growth pattern. Henceforth, price determination should be left to the market as far as possible so that the prices of resources reflect their scarcity.

Second, assessment of the administrative performance of local governments should be shifted from a model that emphasizes GDP growth rates to one that takes an overall perspective, including consideration of the environment. Here, the system of green GDP accounting should be a useful reference.

Third, protection of intellectual property rights must be strengthened in order to enhance independent innovative capability. The up-front costs of research and development can be enormous, and if the fruits of R&D can easily be pirated, profits will not be realized. China is improving its legislation to protect intellectual property rights, but it still has ample room for improvement in the areas of prosecution of violations and fairness of the administration of justice.

Finally, the reform of state enterprises must be accelerated. In the conventional state-owned company, managers act with disregard for corporate performance because the state will step in to cover even a succession of deficits. In the case of state monopolies in particular, there is no need to streamline operations or engage in technological development because profits can be produced even if the business is run inefficiently. When the principles of competition come into play as a result of privatization or other such moves, however, managers have an incentive to produce larger profits, and they will strive to conserve resources and devote necessary funds to technological development. Privatization simply cannot be avoided if China is to make the shift to a market economy.

2.3 Pressing reforms of state enterprises and the financial sector

Having come to this understanding, the Chinese government has been pursuing privatization since the second half of the 1990s under the slogans “hold on to the big, let go of the small” and “strategic realignment of the state-owned economy.” The targets of privatization under the former slogan were only the smaller state enterprises. When the policy of strategically realigning the state-owned sector was adopted, however, large enterprises were also targeted. The policy aims to preserve state ownership in selected industries, such as the supply of public goods, but to promote the withdrawal of all state enterprises, whether large or small, in fields where they are in competition with private companies.² Privatization is making progress among smaller state companies, which are

² This policy is clarified in the “resolution on certain important problems concerning the reform and development of state-owned enterprises” adopted in September 1999 by the fourth plenary session of the 15th Central Committee of the Communist Party of China. According to the resolution, the Chinese government will limit leadership by the state-owned economy to the following four areas and push for privatization in all other areas: (1) Industries related to national security, including arms manufacturing, minting, and industries crucial to the nation’s strategic stockpiling system (such as food and energy stockpiling); (2) industries subject to natural monopoly and oligopoly, including postal services, telecommunications, electricity, railways, and airlines; (3) industries providing important public goods, including water, gas, and public transportation in urban areas, ports and airports, irrigation facilities, and crucial protective forestry projects; and (4) key enterprises in core and high-tech industries, including oil drilling, steel, automobiles, and vanguard areas of electronics.

using such tools as management buyouts (MBOs), but it is moving sluggishly among major state companies. A bottleneck has been the failure to approve the circulation of state-owned shares, which comprise the bulk of the shares of listed enterprises. Fortunately, the stock market reform of 2005 marked a major step toward trading of all state-owned shares. With this opportunity, the road to privatizing even big state companies should open.

To be sure, the authorities state that the objective of their reform of nontradable shares is not to sell the state-owned shares in the market but only to provide equal rights to tradable and nontradable shares, enhance corporate governance of listed companies, and improve the fund intermediation function of securities markets. Probably the authorities have been forced to adopt this cautious stance in order to dispel concern about a worsening of supply and demand in the stock market. But if the state continues to hold on to its nontradable shares even after they are converted to tradable shares, little improvement is to be expected in either corporate governance or fund intermediation through the stock market. For the reform to produce the desired effect, there must be movement toward the privatization of state enterprises through sales of state-owned shares.

In order to enhance investment efficiency, securities market reform needs to be promptly coupled with reform of the banking sector, the main actor in indirect finance. The centerpiece of the banking reform, following infusions of public capital and moves to write off bad debts, is the transformation of the four major state-owned commercial banks into joint-stock banks. Plans to get the banks listed on foreign stock exchanges are now being implemented. As part of this effort, strategic investors in other countries are being invited to assist in improving the banks' efficiency. Meanwhile, financial institutions of other countries have set their sights on entry into China through tie-ups with the big four banks, and a series of capital subscriptions to the banks have been announced (table 3).

Table 3. Foreign Capital Subscriptions to the Four Major State-Owned Commercial Banks (as of December 2007)

		Investor	amount	Stake	Date of agreement
Four major state-owned commercial banks	Industrial and Commercial Bank of China	Goldman Sachs (United States), Allianz (Germany), American Express (United States)	\$3.78 billion	10%	January 2006
	Bank of China	Royal Bank of Scotland (Britain), Merrill Lynch (United States), Li Ka Shing Foundation (Hong Kong)	\$3.1 billion	10%	August 2005
		Temasek Holdings (Singapore)	\$3.1 billion	10%	August 2005
		UBS (Switzerland)	\$500 million	1.6%	September 2005
		Asian Development Bank	\$75 million	0.24%	October 2005
		Bank of Tokyo-Mitsubishi UFJ (Japan)	\$180 million	n.a.	June 2006
		China Construction Bank	Bank of America (United States)	\$3.0 billion	about 10%
	Temasek Holdings (Singapore)		\$1.4 billion	5.1%	August 2005
	Agricultural Bank of China	—	—	—	—
Reference	Bank of Communications	HSBC (Britain)	\$1.75 billion	19.9%	August 2004

Source: Prepared from media reports.

The transfer of shares of state-owned banks to foreign institutions provoked critical comments in some quarters about how state assets were being sold off at less than their true value.³ The introduction of foreign capital nonetheless deserves high marks, since ultimately it will improve bank management and push up share prices. From this standpoint, we can see the Bank of Communications, China's fifth largest state-owned

³ Some people complained that transfer prices were on the low side relative to earnings. There was also talk about how state-owned assets were siphoned away at low prices after having had huge amounts of public funds pumped into them to write off bad debts and build up capital. In addition, the government was charged with violating fairness, a premise of the market economy, by refusing to allow domestic investors to participate in the subscriptions. Public officials and economists responded to the "cheap sales" criticism with the following reasoning. First, when taking in subscriptions from strategic investors, the main objective is to absorb managerial know-how from them and increase the international competitiveness of Chinese banks. In such a situation, there is no way to avoid giving precedence to foreign financial institutions, since compared with domestic investors they possess more vanguard technologies and have a greater wealth of experience. Next, seen from the perspective of the subscribers, capital participation has high risks, such as the possibility of a renewed climb of the bad debt ratios of the big four banks. For this reason, subscribers would have no interest in even considering a deal unless the returns were also high. In addition, the subscriptions were accepted with strict conditions designed to preclude speculative investments, including a ban on share sales for three years and an obligation to dispatch personnel.

commercial bank, as a success story. It acted ahead of the big four banks to draw in foreign capital and secure listings abroad. In 2004 the Bank of Communications received capital from HSBC Holdings of Britain for 19.9% of its shares, and in June 2005 it secured a listing on the Hong Kong Stock Exchange with H shares.

Other Chinese banks have followed the Bank of Communications in listing on the Hong Kong exchange with H shares (the China Construction Bank in October 2005, the Bank of China in June 2006, and the Industrial and Commercial Bank of China in October 2006), and their shares have been performing well.⁴ The rising share prices, which can be seen as a dividend of reform, have presented huge rewards to the banks' domestic shareholders, who own more of the shares than do foreign shareholders. We may say that the capital tie-ups between the state banks and foreign financial institutions have turned out to be a win-win strategy.

Reform of the state banks ought to go beyond listing on stock markets toward privatization in the form of a gradual withdrawal of the government from ownership and management. The reform of the shareholding system and the stock market listings of the big four state banks are but the first step on this journey. There is no guarantee that the actual incentive system and a mechanism for supervising bank management will operate effectively simply because shareholding has been reformed, bank stocks are being traded, and corporate governance of banks takes shape through the establishment of internal rules. For that matter, even if banks take on the form of regular companies complete with boards of directors, auditors, and general shareholders' meetings, the conventional problems will probably remain unresolved as long as the government continues to dominate banks as their largest shareholder. For this reason, it is to be hoped that the government will use the occasion of the listing of shares to reduce its holdings in the big state banks, keeping the road to privatization open. At present the authorities have imposed a limit of shareholding up to 25% of the equity issued by Chinese banks for foreign Strategic investors as a whole, and up to 20% for any single foreign investor. In the future, though, this rule may be relaxed.

⁴ The Industrial and Commercial Bank of China listed H shares on the Hong Kong Stock Exchange and A shares on the Shanghai Stock Exchange simultaneously. The Bank of China and the China Construction Bank listed A shares in Shanghai after first listing H shares in Hong Kong.

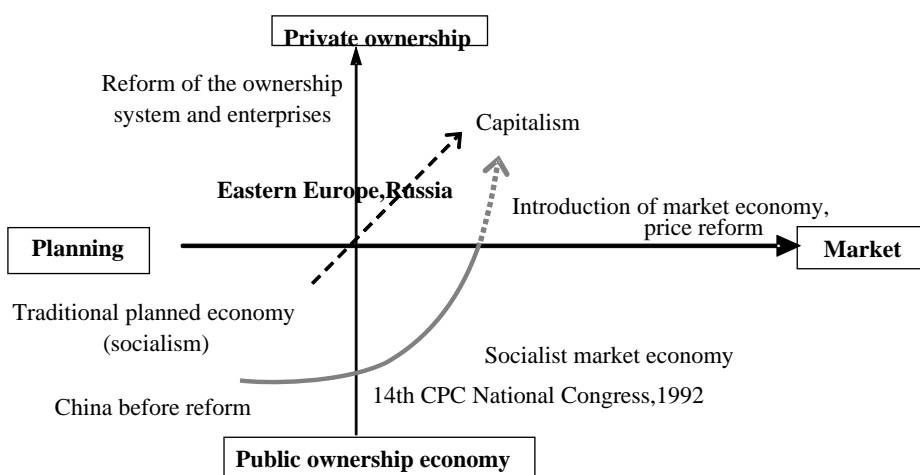
3. Can the Growth Pattern Be Successfully Altered?

Given that the main cause of the Chinese economy's inefficiency is the continuing large presence of state-owned enterprises, privatization promises to be the key to shifting successfully from extensive to intensive growth. Now that reform of nontradable shares has been accomplished, progress is being made toward dismantling the dual structure of the stock market—a bottleneck to privatizing state enterprises. Nonetheless, the obstacle of socialist ideology, which upholds public ownership, remains in place. Complicating the situation, many state enterprises enjoy monopolistic positions and draw in huge profits, and they are resisting privatization in a bid to protect their vested interests.

3.1 Clearing away the ideological obstacle of public ownership

The ideology by which China previously ran its economy posited that public ownership of the means of production is, like the planned economy, an essential element of a socialist economic system. During the days of the planned economy, accordingly, no privatization was allowed, and the only companies in existence were public enterprises, either state-run enterprises (later renamed state-owned enterprises) or collectively-owned enterprises. China's experience made it clear, however, that this setup led to a lack of economic vitality and poor efficiency. Based on this lesson, China in the late 1970s embarked on the policy of reform and opening up, and at the 14th National Congress of the Communist Party of China in 1992 it officially scrapped the planned economy. The nation has since made its goal the development of the "socialist market economy." The socialist market economy was initially understood to be a market economy based on public ownership, however, and reform of the ownership system has lagged behind market reform as a result (figure 4).

Figure 4. Change of Systems in China Through Incremental Reform



Source: Prepared by the author.

Reform of state enterprises began with a shift to the shareholding system, and through infusions of private funds, many companies with a mixed form of ownership came into being. At the same time, the definition of public ownership has evolved. At the 15th National Congress of the CPC in 1997, it was decided that the state (or collectively) owned portions of “shareholding enterprises” (as joint-stock companies are called in China) would be recognized as part of the publicly owned economy. Then, in the “resolution on certain important problems concerning reform of the socialist market economy system” adopted in October 2003 by the third plenary session of the 16th Central Committee of the CPC, the shareholding system was recognized as the major form of public ownership. At that point, the whole of any enterprise controlled by the state (or a collective) came to be recognized as part of the publicly owned economy, even if state ownership fell below 50% (absolute majority), provided that the state held a larger share than any other shareholder (relative majority). However, the resolution contained a reference on the need to preserve the central position of public ownership, so it cannot be said that the ideological obstacle to privatizing state enterprises has been fully removed.

Even so, the center of the Chinese economy is shifting steadily from public to private ownership. With the sharpening of the contradiction between the economic base and the ideological superstructure, it has become hard for the authorities to uphold the principle of public ownership of the means of production. The government will probably be forced to expand the definition of public ownership to include joint-stock companies in which the state has no stake, and ultimately it will need to abandon the public ownership system altogether. Ever since the planned economy was officially replaced by the market economy at the 1992 CPC National Congress, adherence to public ownership has been the foremost obstacle to productivity improvement. Its abandonment, accordingly, should enable the economy to take a further leap forward.

3.2 Expected resistance to privatization from monopolistic state enterprises

Over recent years state enterprises, especially large ones directly controlled by the central government, have been earning large profits. These are the result of monopolies, however, not superlative management, and the damage they are causing is growing serious.

First, monopolies injure the interests of consumers. What the state companies see as handsome profits they have earned are nothing other than exploitation of the consumers (households and companies) who purchase their goods and services. In particular, when shipment prices are raised by upstream state enterprises with a virtual monopoly on resource development, the numerous downstream companies all see a rise in their production costs. In actuality, the high returns at state enterprises enjoying monopolies have caused performance to deteriorate at other enterprises.

Second, the existence of monopolies is an impediment to introducing competitive principles and opening the market wider. In order to protect their own interests, monopolies are inclined to pressure public officials into raising high barriers to market entry, which make it even more difficult to introduce competitive principles and open the market wider.

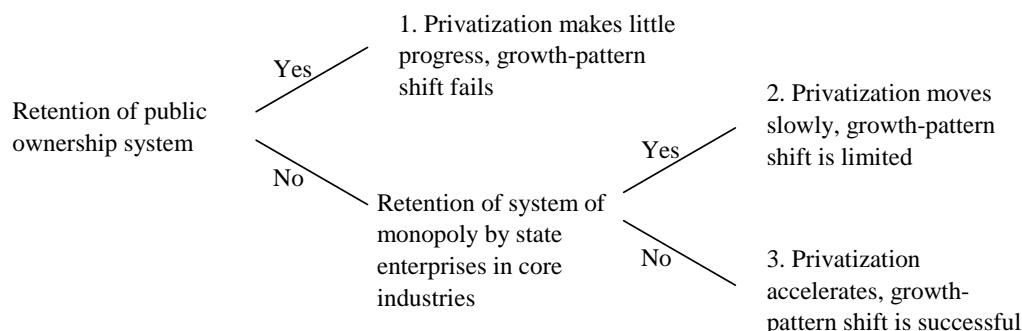
Third, the existence of monopolies is injurious to social fairness. In actuality, the employees of monopolies in the energy, telecommunications, and transportation industries enjoy disproportionately generous incomes and welfare benefits relative to the profits of their enterprises.

Finally, monopolies have no incentive to improve efficiency because they can make profits without any special effort, and so they lack the power to compete in international markets. In fact, even though China has come to be called the factory of the world, the leading producers are the foreign companies in China. Some of China's state companies place among the world's top 500 companies in the rankings published each year by Fortune, but they hardly make any contributions to Chinese exports. It is true that they reinvest a substantial proportion of the profits they do not return to the state. Unfortunately, however, this investment is not necessarily used effectively to augment their corporate value. The same can be said of their overseas mergers and acquisitions, which have been rapidly increasing of late.

These negative features that go hand-in-hand with monopolies need to be corrected. The third plenary session of the 16th CPC Central Committee in 2003 resolved to tackle reform in monopolistic industries, but the State Council's State-Owned Assets Supervision and Administration Commission, which represents the government as the shareholder, is striving to strengthen the monopolies of the state enterprises. Seeing its mission to be the fostering of large and powerful state enterprises, it is promoting mergers among the big ones. This is a dangerous course to pursue, since it provides ammunition to vested interests opposed to privatization and also runs against China's goal of building a market economy premised on fair competition.

3.3 Scenarios for the Future

Will privatization progress in the years to come, bringing about a successful shift in the growth pattern? The answer will depend on whether it is possible to remove ideological barriers and overcome resistance from vested interests. In this regard, three alternative scenarios can be envisaged (figure 5).

Figure 5. Three Scenarios for the Future

Source: Prepared by the author.

1. In the event that public ownership is retained (privatization is opposed in principle), there will be little progress toward privatization, and the growth-pattern shift will end in failure.
2. In the event that public ownership is ultimately abandoned but the monopolistic setup of state enterprises is retained in core industries (privatization is affirmed in principle but often opposed in practice), the pace of privatization will be slow, and the growth-pattern shift will remain limited.
3. In the event that public ownership is ultimately abandoned and the monopolistic setup of state enterprises is dismantled in core industries (privatization is affirmed in principle and in practice), privatization will accelerate, and the growth-pattern shift will be successful.

The second scenario is the most likely and should be seen as the standard scenario.

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