China – the new global player

The Chinese economy: How much market – how much state?

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The Chinese economy seems to be one of today's greatest enigmas. On the one hand, observers are anything but shy to postulate a dynamic development which has lasted for a good quarter century by now and has already been overshadowing the post-war "Wirtschaftswunder" economies of Germany, Japan and Southeast Asia. On the other hand, economists are facing serious problems when trying to explain the forces at work: According to standard property rights theory, the prevalence of ambiguous property rights structures in China should rule out any sustainable economic development dynamics (Demsetz 1967); privatization of its state-owned enterprises comprises the final step of China's transformation process while standard transformation literature puts it at the very beginning of systemic change (Gelb/Gray 1991); lacking empirical evidence of positive externalities and spillover-effects from China's huge inflows of foreign direct investment (FDI) puts the real value of China's FDI attraction into doubt (Hu/Jefferson 2002, Huang 2003). And then there is a final paradox to be unraveled: Postulating the superiority of a market economy over any central planning or hybrid economic system, how can it be that China has advanced to become the growth engine of the global economy (IMF 2005)?

Market, plan and more

There are strong indications that China is working according to market principles. Already two years ago, price reform was nearly completed, leaving only a few strategic goods in the control of state agencies. Today, the private sector is already contributing about two thirds of China's GDP; foreign invested enterprises contribute about one third to China's gross industrial output. Products valued at about one third of China's GDP are sold on the global markets and stand the test of global competition. The entrepreneurial spirit and capitalist acumen of Chinese businessmen has already become a well respected force in global business.

At the same time, however, there still exists a comprehensive set of five-year and single-year plans covering all strategically important aspects of the Chinese economy. The new, already 11th Five-Year-Plan, is due to be promulgated at the end of this year and will cover the period 2006-2010. This new set of economic plans includes much more than just the general outline of economic development goals being publicized at the outset of the plan period. In the unpublicized sphere there exists a comprehensive set of detailed plans for industries and individual enterprises. These plans are much more flexible than the directives issued in former periods[1], nonetheless, they do have a very significant impact on the top management of China's leading enterprises.

Despite a lot of market, "chaotic" mechanism is not trusted

While the Chinese government has certainly given market forces much more leeway than in former times, it still is not willing to leave the nation's economic development in the hands of such a "chaotic" mechanism. Based on the premise that market forces should be the dominant coordination mechanism for day-to-day business interaction, the central government understands itself as the strategic mastermind of national (economic) development. This strategic approach to national economic development, however, is not the only way in which government agencies are involved in China's business sector. Local governments as well are on a large scale engaged in the business activities of their local enterprises. These local politico-business alliances, however, are less concerned with the strategic issues of economic development, but are rather the product of rent-

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[1] The tenth Five-year-plan (2001 to 2005) was the first not to include any directives, but rather to rely on indicative planning and indirect means of control and regulation.

seeking activities and designed for short-term profit/utility maximization.

China's master-plan for economic development and "China Inc."

China's economic policy makers are not content with China being the global center for labor intensive manufacturing. While industries establishing labor-intensive production capacities must be promoted in order to create jobs for China's growing labor force[2], the real focus of China's industrial policy is the promotion and establishment of higher value-added, technology-intensive industries. As this policy is designed to always venture one step ahead of China's present comparative advantages, the attraction of new technologies embodied in foreign direct investment projects constitutes an inevitable element in the government's quest for industrial upgrading. But China's industrial policy does not stop with the selective promotion of foreign investment projects. Rather, the domestic business sector is the most important target of these policies. The creation of large Chinese enterprises, "national champions", featuring state-of-the-art technological capacities and exerting global leverage has been a prominent goal of China's economic policy makers since the early 1990s.

Tight control over national champions

The political leadership in Beijing believes that in order to advance its quest for substantial political influence on a global scale and strengthen its independence from established powers, the existence of Chinese "global players" that are fully integrated in the oligopolies of the global markets will be indispensable. Strong domestic enterprises with global reach are equated to political leverage. Furthermore, the political circles realize that China's industrialization and modernization process is consuming more resources than the country can provide. In order to secure China's energy needs as well as the capital resources and raw-materials it needs for further development, the country will have to rely on its companies to venture out and secure stakes in the global market place.

In its strategic approach to economic development and interaction with the business sector, the central government relies on various agencies. Most important of these are the National Development and Reform Commission (NDRC), which has evolved from the former State Planning Commission, and the State Council's Development Research Center (DRC). These organizations take a leading role in the formulation of China's macro-economic economic development strategies. The State-owned Asset Supervision and Administration Commission (SASAC) of the State Council has been entrusted with the micro-economic coordination and regulation of the nation's top (state-owned) companies. In order to strengthen government control it is invested with rights that before had been dispersed among different ministries and agencies.

SASAC has been holding a firm grip on China's "national champions" subjecting the top management of the enterprises in its realm to strict monitoring and disciplinary surveillance. Consequently, SASAC does have substantial leverage over the behavior of individual enterprises and its managers, although these enterprises are embedded in a supply/demand driven environment and are not subject to plan directives. It has taken up the government's doctrine and strives to create 30 to 50 large Chinese enterprises and holding companies of international standards until the end of this decade. Enterprises thought to possess the potential of becoming global players are promoted by a number of preferential policies, including preferential provision of bank credit, access to the capital market (issuing of stock and corporate bonds), promotion of foreign direct investment activities, support for the creation of research institutes, etc. In addition to these direct support measures, the national champions are greatly benefiting from regulatory policy and formal institution building that is promoting their expansion to the detriment of other domestic and primarily foreign competitors.

Seen in perspective, even without detailed plan directives, the central government is very much involved in the pro-active design of industry structure and the opening of development paths for its "national champions". In order to do so, it can rely on powerful organizations staffed with some of the best trained people in the country. This concept of the central government and its agencies functioning as the mastermind behind China's long-term economic development gives rise to the notion of "China Inc.", where politics and the business sector form an integrated organization. As a matter of fact, the case of CNOOC's bid for the US American oil corporation Unocal, which in August 2005 was abort-

[2] According to UN projections, China's population in the age bracket of 15 to 64 will rise from the present 890 million to 1 billion by 2015.

ed due to strong political resistance in the United States, provides a perfect example of how, in modern China, political interests become intertwined with individual business strategies and may even dominate the latter. In how far the CNOOC-Unocal deal would have made sense from a business perspective is open to question. It would, however, have fitted perfectly in the government's policy to improve the nation's access to natural resources. Against this background, it becomes understandable how CNOOC, which would never have been able to stem the $ 18.5 billion it was bidding for the US company, was able to secure the necessary financing by means of very substantial soft loans guaranteed by the state.

State and business on the local level

Next to the top-down approach described above, we can also identify a second, more or less horizontal linkage between the state and the business sector. This nexus is founded on bilateral alliances between local governments on the provincial, city or county level and local business. Its raison d'être lies in the prevalence of grey market structures, which make it rational for local cadres as well as business managers to seek close bilateral relationships. In the absence of strong macro-economic institutions to protect a market system based on fair competition, local government organizations are still in a position to control the access of local firms to important inputs and licenses. Given this monopoly, however, the cadres working in these very government organizations are evaluated by central government and party organizations according to their ability to promote economic development, create new jobs, etc. in their localities. I.e. they rely on strong business partners. As a consequence, there exists a strong interdependency between local government and business, which both parties ideally solve by teaming up in alliances, thereby reducing their risk exposure and earning rents beyond the competitive equilibrium.

An important side effect of these local-level politico-business alliances consists of their inclination, or even nature, to evolve in a direction that runs counter to the interests and declared policies of the central government, i.e. they lead to a reduction of overall "state capacity". As a matter of fact, a good deal of China's boom-and-bust cycles, the periodical existence of over- and under-capacities in various industries as well as the "unstoppable" generation of new nonperforming loans are caused by this juxtaposition of central and local interests.[3] Local governments promote the development of "their" enterprises irrespective of any directives by central government agencies targeting loan-expansion, industry-development, land allocation, environmental protection etc. The case of *Jiangsu Tieben Iron & Steel Corp., Ltd.* (see box) provides a perfect example of this mechanism.

A market economy with "Chinese characteristics"?

How to classify the Chinese economic system? According to EU terminology, China is a "non non-market economy"; the Chinese political leadership has termed the phrase "socialist market economy with Chinese characteristics". All of this seems to provide a large scope for interpretation. What we do observe in China, however, are strong market forces on a micro-economic level, which are not complemented by the corresponding macro-economic institutions. On all levels, the government is involved in business issues.

Long-term strategies of the central government vs. ...

There are two very distinct forms to be differentiated, in which the state (i.e. government organizations and their individual representatives) interferes in the market process. On the one hand, we can observe policies based on a comprehensive long-term strategy, by which the central government intends to promote Chinese enterprises in the global market place. For the time being, this policy approach has created positive net-effects for the economy and its global competitiveness. Still unthinkable only a few years ago, the Fortune 500 list today includes more than a dozen Chinese companies. And, nurtured by the government's "national champions" policy, dozens of Chinese enterprises have already reached a developmental stage where they are no longer content with catering to their domestic customers or with producing goods for foreign brand owners, but are venturing out on the global markets. But with China leaving the early stages of modern-age industrialization and entering more complex, knowledge-intensive stages of economic development, this interventionist policy approach will have to be abandoned. China's policy of creating "national champions" by means of selective support measures and an accommodating regulatory policy as well as institution building calls to mind the unsustainable industrial

[3] China's central bank makes local governments responsible for about one third of China's overall non-performing debt.

Box

Jiangsu Tieben Iron & Steel Corp., Ltd.
– A case-study of a local-level politico-business alliance –

In June 2003, construction on an 8.4 million t/a steel mill started in a small township of Changzhou, Jiangsu province. 10 months later, after using up Yuan RMB 2.56 billion of bank loans, construction was stopped on direct order of China's premier Wen Jiabao. Since then the construction ruin of *Jiangsu Tieben Iron Co., Ltd.* has become a symbol of a systemic coordination failure in China's economic and political system and its investment regime in particular. (*Nanjing Steel* has now taken over the facilities and will continue the project, but on a drastically reduced scale.)

The short-lived story of *Jiangsu Tieben* began with the vision of private entrepreneur Dai Guofang to create a new steel empire that would surpass China's leading steel producer BaoSteel. Dai's high flying aspirations were founded in a vita marked by extraordinary entrepreneurial success. Starting as an ordinary construction worker without any formal schooling, he had started his career as a private entrepreneur by trafficking in iron scrap until he entered the steel business by investing in three 30 t/a electric steel mills. From there on he quickly expanded his steel production activities and step by step leased (and turned around) various run down plants of altogether six state-owned enterprises. In 1996, he eventually founded *Jiangsu Tieben Iron Co., Ltd.* in Changzhou city. In 2003, this private company already produced 800,000 tons of steel. Now the time seemed to have come for the next step in Dai's career.

The entrepreneurial spirit of Dai alone, however, would not have sufficed to start the new *Jiangsu Tieben* steel mill venture. In order to do so, top decision makers of the local political circles had to provide substantial support. And, as a matter of fact, the local political elite was more than willing to promote the project. Economic development, tax revenue and job creation have become the most important criteria for political success and career advancement in China's party and administrative 'nomenclatura'. As a consequence, China's local decision makers are first of all striving for the facilitation of economic growth in their constituencies – regardless of potential negative externalities that might endanger overall macroeconomic stability, harm economic development in neighboring areas or become visible only after they have moved on. In the case of *Jiangsu Tieben*, the head of local government had just been transferred to the city and was looking for ways to promote economic development in the region when Dai introduced his plans in 2002. The plans were received enthusiastically. More than that, Dai was prompted to enlarge his original design and increase the projected production capacity fourfold to more than 8 million t/a.

... short-term alliances between local politicians and firms

In order to make the project possible, Changzhou's political and administrative bodies greatly transgressed their authority. Once the project design had reached its final stage with 8.4 million t/a steel production capacity and an overall investment volume of Yuan RMB 10.59 billion, it greatly surpassed the authorization limits of local administrative bodies. In order to prevent the project from being stopped by central authorities, the project was therefore split up into 22 individual projects, each of them small enough to fall within the authorization limits of local administrations. The transgression of existing regulations, however, did not stop here. Against existing law, *Jiangsu Tieben* was allotted land use rights over a total area of about 630 hectares of land, 436 hectares of which had been taken into possession in March 2004. Of the latter, 310 hectares were agricultural land, which according to existing regulations was not to be transformed into industrial usage. An environmental impact report, which for this kind of project is prescribed by law, was neither prepared nor asked for when the project was authorized by local administrative bodies. In order to secure the financial means for the project, local bank offices were pushed to provide multi-billion Yuan RMB credit lines for the project, although the paid-in capital amounted to only Yuan RMB 676 million, or a mere 6 percent of the total investment volume.

With China's central governmental and party organizations immersed in the internal struggles accompanying the transfer of power to the new leadership group of Hu Jintao and Wen Jiabao in 2003, local organizations had much leeway to put their own policies into effect. But even in "normal" times, all the irregularities depicted would probably not have resulted in the central government bringing the project to a grinding halt.

"Unfortunately", the overall economic development resulted in a situation in which central government officials felt the need to intervene in order to prevent the economy from overheating and to rectify structural imbalances. An enormous investment surge in 2002 and 2003 had already created bottlenecks in certain key sectors of the economy. The danger seemed to be imminent that the booming Chinese economy would go bust and enter a period of prolonged depression if the central government failed to bring the economy back on a sustainable growth path. The problem was aggravated by additional problems evolving in the Chinese steel sector. Based on a generally accepted projection that China would consume 330 million tons of steel in 2010, the fact that Chinese steel makers were in the process of expanding their production capacities to at least 400 million tons in 2005 raised serious concerns in Beijing. In order to prevent the creation of massive overcapacities – which would eventually result in a poor return on capital in China's steel industry as well as a new addition of non-performing loans in China's fragile financial sector – Beijing had to intervene and stop new investment projects. *Jiangsu Tieben*, an investment project designed to incorporate very high technological standards, was certainly not the best project to stop in order to improve average productivity in China's steel industry. But it was a project whose cancellation could be instrumentalized to communicate a very strong warning to other actors engaging in similar undertakings.

The *Jiansu Tieben* case highlights the extraordinary entrepreneurial dynamics existing at the micro level of China's national economy, as well as the lack of a macro-economic coordination mechanism, that would channel these activities into a symbiotic context. Instead ex-post macro-regulation results in a disruption of the economic process and wastes entrepreneurial as well as financial resources.

policies in Korea and South East Asia that eventually led to the dramatic events of the "Asian crisis" of 1997/1998.[4]

On the other hand, we observe the phenomenon of local politico-business alliances that often run counter to central government policies and follow rather short-term rent-seeking motives. As the *Jiangsu Tieben* case documents, local politicians are not only still in a position to provide highly protected niches for enterprises of their favor, but are actually facing strong incentives to do so. As a conse-

[4] As a matter of fact, China's "national champions" policy in combination with local politico-business alliances come at the cost of a highly underdeveloped competitive system. Despite the WTO principle of "national treatment" there is still no level playing field for all economic subjects in China. As a result, the allocation of resources and therefore the industrial structures created are to a considerable extent not the outcome of market processes but rather of human design. Their sustainability is open to doubt. The situation is aggravated by pervasive corruption, which has already prompted Jiang Zemin, late President of State and General Secretary of the Communist Party of China, to declare the struggle against corruption as "a matter of life and death of the party".

quence, the Chinese economy is characterized by a multitude of politically monopolized and isolated markets that are not corresponding with each other. Due to this constellation, market-based tendencies working towards the establishment of macro-economic equilibria cannot take effect and the Chinese economy continues to feature pronounced boom and bust cycles and a highly volatile development path characterized by the sequential prevalence of under- and overcapacities in its major industries. The Chinese "market" economy seems to neither lack entrepreneurial initiative nor capitalist savvy – it simply lacks an integrating force that would bring all these elements into a symbiotic context.

Paradoxically, China will need a stronger – central – government in order to establish a smoothly functioning free market system. The central government must be strong enough to bring the enormous entrepreneurial initiative that can be observed in all parts of society into a rule-based national context. It must stop local governments from colluding with local business and resist lobbying activities by powerful interest groups that try to meddle with the competitive "level playing field". And at the same time, the central government will have to retract from its ambition to steer China's economic development and especially the business development by discretionary measures.

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