eurasia **group**
Defining the Business of Politics.™

Testimony of
Dr. David F. Gordon
Head of Research and Director, Global Macro Analysis
Eurasia Group
Washington, DC

Thursday, February 15, 2012
11:15 AM

The Competitive Challenges Posed by China's State-Owned Enterprises

"We have one important piece of experience of the past 30 years: That is to ensure that both the visible hand and invisible hand are given full play in regulating the market forces."
-Chinese Premier Wen Jiabao

Chairman Shea, Vice Chairman Reinsch, and distinguished members of the Commission, thank you for inviting me here today. My name is David F. Gordon and I am Head of Research and Director of Global Macro Analysis at Eurasia Group, the global political risk analysis firm. Prior to Eurasia Group, I worked in the US government for nearly two decades, culminating in service as Director of Policy Planning under Secretary of State Condoleezza Rice.

Thank you for your leadership on and attention to this issue, which is already of critical strategic and economic importance to the US, and will be even more so in the coming years. The timing of today's hearing is especially appropriate, as China's next leader, Xi Jinping, is currently in the US lobbying for a more open investment environment. I will begin my testimony by outlining the scale and scope of the issue at hand.

China's state-owned enterprises (SOEs) present significant strategic and industrial challenges to US firms and the US government. Beijing has redoubled its efforts to build its companies into globally powerful entities in established and emerging industries. Substantial state support skews the competitive landscape for US companies and complicates US industrial and business policies both inside and outside the People's Republic. The challenge is most severe in China's domestic market, in which the US government can do little to protect US firms from Beijing's vast array of preferences for domestic industry. Yet the challenge extends far beyond China itself. As Chinese firms ascend the value chain and become industry leaders, their presence is increasingly felt in global markets. This will frustrate US firms facing unequal competition from Chinese competitors. It also presents economic and strategic opportunities for the US government and US firms as countries around the world seek to avoid dependence on Beijing. The next frontier for China's SOEs is the US market, where US policymakers will struggle to balance between national security and trade priorities on the one hand, and the promises of inbound investment and employment growth on the other.

What is a State-Owned Enterprise in China?

SOEs are a defining feature of the Chinese economy. Yet despite their prominence, Chinese SOEs are enormously diverse in scope, scale, and influence, and accounting for this diversity is crucial in accurately

Executive office
475 Fifth Avenue
14th floor
New York, NY 10017
t +1 212.213.3112
f +1 212.213.3075
www.eurasiagroup.net

Washington office
1818 N Street NW
7th floor
Washington, DC 20036
t +1 202.298.6300
f +1 202.298.6276

London office
30–31 Great Sutton Street
1st floor
London EC1V 0NA
t +44 (0) 20.7553.9820
f +44 (0) 20.7553.9830

describing the challenges that they pose for the US. The term "SOE" itself refers to a vast array of public, semi-public, and even nominally private enterprises, all of which benefit enormously from government support and many of which have expanded their profile and influence in the Chinese economy in recent years. Such "sub-sovereign" actors sit at the nexus of the state and the market, but their relationship with the state (or, for that matter, the market) is not always clear or uniform—and neither is the ability of the central government to influence their behavior. Indeed, even the largest and most powerful SOEs have in some cases flatly contradicted Beijing's broader policy goals. Assuming unanimity among the SOEs and their manipulability by Beijing is a mistake that obscures their true nature.

The most prominent SOEs are the centrally administered SOEs, companies operated by China's central government, often as the majority owner (though with subsidiaries listed in Hong Kong). These state-administered SOEs, which comprise some of China's largest companies, are distinct from but related to the thousands of locally-administered, smaller SOEs sprinkled throughout the country. All of these companies, large and small, are explicitly funded and administered by the Chinese government.

The behemoths—first among China's sizable slate of SOEs —are Sinopec, CNPC, and CNOOC, which collectively comprise the national oil companies (NOCs). Undoubtedly, the state exerts sizable influence over the behavior of the NOCs and other major SOEs like them: the bureaucracy intervenes in domestic pricing practices and has power over crucial personnel appointments. Both Sinopec and CNPC, however, retain power and influence commensurate with their former status as state ministries—a higher rank in the Chinese political hierarchy than the State-owned Assets Supervision and Administration Commission (SASAC), the central authority that nominally oversees them. As a result, the NOCs are in some cases able to contravene the central government in Beijing. For instance, despite a veneer of coordination surrounding China's outbound investment strategy—which has rapidly accelerated since 2009—China's NOCs have in a number of cases actually bid against each other for new oil extraction projects in various parts of the globe.

Equally important as the SOEs, however, and presenting a comparable—and in some ways identical—challenge are the ostensibly private firms that Beijing supports explicitly or implicitly as "national champions." Indeed, connections between many large indigenous firms and the government are incredibly murky in China. The true ownership structure of many enterprises is opaque; many businesses—and their owners—intentionally obfuscate their status. Literally thousands of firms in China turn to state support for policy incentives and financing channels. This is particularly true at local levels, at which a tremendous amount of complicity exists between bureaucrats and private enterprise.

In part, the state's industrial policy goals drive this complicity. Beijing is dedicated to building "national champions" and promoting domestic innovation. Yet the government does not clearly delineate its support among the nation's thousands of public and private companies. Instead, it provides generous and plentiful tax breaks and political protection for firms aligned with Beijing's broader goals. This comprises the so-called "indigenous innovation" program: an industrial policy that seeks to catapult Chinese firms into the ranks of high-end manufacturing and global technological competitiveness. The dearth of internationally renowned Chinese brands and Chinese technologies is of great concern for the leadership, and an emphasis on domestic innovation has intensified in recent years. China's government offers significant support to industries deemed strategic, including aviation, autos, heavy machinery, steel, textiles, equipment manufacturing, petrochemical, shipbuilding, light industrial manufacturing, electronics and information technology, non-ferrous metals, and

logistics. In all these industries, regulators favor powerful SOEs and strong domestic private-sector firms alike through standards-setting, generous financing terms well below commercial lending rates, and preferences in government procurement.

Given the financial incentives involved, many private Chinese firms dedicate themselves to fulfilling the state's initiatives in the hopes of winning preferential subsidies or receiving a formal designations as "national champion," which brings with it even more support in the form of a overwhelmingly favorable regulatory and tax environment. Domestic industry groups, mostly dominated by major Chinese firms, have also become more influential in policymaking and thereby better positioned to slant domestic regulatory policy in their favor (a phenomenon often termed "regulatory capture"). The underappreciated irony is that these developments subject not only foreign firms but also many smaller Chinese private sector companies to competitive disadvantages in the China market. In fact, powerful SOEs and private-sector national champions with more substantial resources to devote to R&D and defending market share squeeze many smaller Chinese private firms out of the market. Indeed, in China, the pathway to profitability very often has less to do with business operations than with successfully obtaining state support.

Underpinning this complicity between the state and industry is a weak and pliant legal regime. In China, economic reforms have outpaced political and legal reforms. This quite rightly fosters public and investor distrust in the Chinese legal system. More importantly for the purpose of SOEs, however, it creates a void for brokering economic and business outcomes that the state is more than happy to fill. Private and foreign firms are left with little recourse: local courts generally yield to the preferences of local authorities and make politicized judicial decisions. China has made efforts to improve its legal regime, as it is well aware of the dilatory effects of a broken legal system on China's attractiveness as a foreign investment destination. But adjustments remain modest and the ruling Communist Party keeps tight control of the judicial system. The overall environment, then, has actually worsened for foreign firms, even as the legal regime itself has improved incrementally.

In sum, the Chinese government explicitly owns many firms. But these firms do not necessarily doing the government's bidding—at least not always. Meanwhile the true ownership of some other Chinese firms is simply unknowable. And among those that are nominally private, many of them still seek to tie closely to the government in the hopes of winning favoritism and financial support. This tumultuous system—or, more truly, complex web of systems—presents an extremely vexing policy dilemma for US policymakers.

The Future of SOEs in China

The question is whether the Chinese government will remain willing to manipulate the domestic market and nurture SOEs over time. Two major trends in China today strongly suggest that the trend toward state control may be lasting. First, the government's heavy-handed and interventionist response to the 2008 global financial crisis raises the possibility that Beijing will continue to strengthen SOEs at the expense of private enterprise over the longer-term. Second, a surge of popular and economic nationalism among the Chinese public—both organic and deliberately inculcated by the regime—has fueled the rise of SOEs and national brands. That will prove a lasting motivation for the government to stay involved in picking domestic winners and losers, and in helping its own firms outcompete foreign players.

The financial crisis and SOEs

Unquestionably, Chinese recovery from the financial crisis occurred at the expense of the domestic private sector. Government funding bolstered the balance sheets of state-owned companies and squeezed private firms—especially small and medium-sized companies. Much of the allocated stimulus went to state-owned or state-affiliated enterprises, especially in the nine "crisis-stricken" industries strategically targeted for support: electronics, petrochemicals, metallurgy, steel, automotive, light industry, textiles, shipbuilding, and telecommunications. This support severely diminished, and continues to diminish, the possibility of foreign gains in these sectors. The funding also emboldened and enabled SOEs to acquire smaller private sector competitors, many of which suffered in the global economic slowdown. The resulting consolidation and reduction in competition restricted the investment environment for foreign companies competing with SOEs and powerful private firms, with the policies of central and local governments explicitly and intentionally buttressing these trends.

Economic nationalism

Beijing has traditionally felt overreliant on foreign investment while its domestic players have lagged in technology and international managerial competence. The government has accordingly begun shifting policy to favor the development of domestic firms, and employs nationalism as a political and economic instrument to justify its initiatives. As a result, the investment environment for foreign firms in China is increasingly challenging. Technology transfer has become a frequent precondition for foreign investors' participation in the Chinese market. Beijing has also identified and virtually closed to foreign investment a number of strategic sectors, including telecom, aviation, shipbuilding, oil/petrochemicals, and steel. And the government has stoked fervor over foreign acquisitions to block the purchases of domestic companies.

What comes next?

The most likely scenario in the short term is that Beijing continues to offer substantial support and protection to strategic industries and maintains a pivotal role in capital allocation for both private and public enterprises. This will be a great competitive challenge for US firms, especially in high-technology industries. Indeed many US firms in a wide swath of industries have systemically underestimated the speed and strength with which state support has enabled competition to emerge in their space. For now, many US firms maintain their competitive edge in international markets because they can innovate technologically in ways that Chinese firms are unable to do themselves. The competitive threat is growing, however, and the overall environment in China worsening for multinational companies.

Over the longer term there is reason to be more optimistic: Beijing will be compelled to buttress small-and medium-sized private enterprise within China because the Chinese economy will require those entities for continued job growth. And given their innovative edge and more efficient use of capital, both domestic and foreign private firms maintain intrinsic advantages over the SOEs. But the Chinese economy will require significant readjustment before Beijing fully comes to terms with these realities.

Outlook for US Policy and US Industry

The biggest challenge is in the China market

The biggest challenge for US industry, and thus for the US government, is the lack of a level playing field within China as domestic Chinese firms benefit from massive state support. The Chinese government continues to favor domestic enterprises through financial and regulatory incentives and by tolerating weak enforcement of intellectual property rights (IPR) protections. In recent years Beijing has outlined expansive plans for new regulatory and direct fiscal incentives for a host of high-end manufacturing and technology-oriented sectors in which US industry currently has a global advantage, including but not limited to nuclear power, aircraft, automobiles, medical devices, and agricultural equipment. Beijing also maintains broader clean and renewable energy development goals that help Chinese firms compete in industries increasingly seen as major potential drivers of employment and growth in the US. And within China IPR enforcement will remain weak, and the avenues for IP leakage are proliferating—driven by an increased willingness by Beijing to set standards and mandate technology transfers for investment approval.

The preferential treatment that large domestic players receive is altering the competitive landscape for foreign companies in China, particularly in high-technology sectors. Chinese state-owned companies continue to lobby the government to restrict market entry for foreign firms and channel funding to domestic technology research, citing fears of overcapacity and the need to build indigenous expertise. One particularly troubling policy for foreign companies is restricted access to China's government procurement market. Last year Beijing promised to modify this practice, but implementation of that promise is not evident as of yet.

In this environment, protection of the intellectual property (IP) of US firms in the China market is unlikely to improve substantially. Poor enforcement of existing nationwide regulations at the local level will continue to be the major concern. At the same time, regulators will more often impose on foreign firms investment criteria that mandate technology transfers or cooperation with domestic industry. Already many foreign investors struggle with the government's increased willingness to impose standards for domestic markets, especially in high-technology fields. To meet the standards, foreign firms are often forced to submit detailed information on production processes. This regulatory hurdle is a major source of IP leakage and will continue to be so for the foreseeable future. Beijing is unlikely to seriously bolster its IP protection regime until domestic Chinese industry demands it—driven by its growing capability to drive innovation on its own.

SOEs are increasingly competitive globally as well

Beijing not only empowers its state-owned enterprises domestically. It is also determined to transform many of them into globally competitive "national champions." This goal lies at the heart of Beijing's favored lending rates and encourages consolidation in targeted industries. Beijing now allows these firms to borrow from the state's massive foreign exchange reserve holdings to conduct outbound purchases. Conveniently, the goal of promoting "national champions" also aligns with China's energy security goals. Chinese firms in key sectors from petroleum to metals to shale gas are finding growing success in pursuing outbound investments in developing and developed markets.

But Beijing's outbound engagement has raised a new set of problems for China. Many Chinese outbound

investments in the developing world have relied on quid-pro-quos related to infrastructure and other development deals. Striking these kinds of deals, however, is increasingly difficult for China. Host governments and populations, most notably in Africa, have begun to push back against Chinese firms' employment policies and perceived exploitations. Meanwhile Beijing has struggled to coordinate the activity of its own firms abroad, and to align that activity with the government's diplomatic goals. In recent months Beijing has attempted to manage corporate interests and avert mounting economic losses in overseas ventures. These efforts will yield limited results: some state-owned firms will become more risk-conscious. Yet oversight of outbound investments will remain fragmented, like a symphony without a conductor. And many firms, especially nominal or actual private companies, will actively disregard cumbersome approval processes and government guidelines, creating additional political headaches for Beijing.

Specifically, even though China's political elite support outbound investments and view them as integral to their firms' development, Chinese policymakers are increasingly aware that greater commercial exposure overseas will require greater involvement in global affairs—a responsibility that Beijing would prefer to avoid. In the first two months of this year alone, investments in Sudan and Iran have demonstrated the need for a careful balance between corporate goals and diplomatic priorities. It will become more and more difficult for China to remain diplomatically agnostic as its firms expand and diversify their commercial interests internationally.

This presents economic and strategic risks for the US, but also significant opportunities. Undoubtedly, Chinese SOEs will become more globally competitive in ways that threaten US competitiveness. Chinese overproduction will continue to deluge new and emerging industries. At the same time, stronger Chinese competitors will gain global market share in established industries such as telecom and railways. Yet China's missteps, and the growing resistance in the developing world to perceived exploitation, will create opportunities both for US firms and for US diplomacy. Already, China's neighbors in Asia are seeking closer strategic and economic ties with the US to offset China's influence. Burma, in which a government long coupled to Beijing for economic and strategic support and outside investment is now pursuing an aggressive engagement strategy with Washington, is a perfect example. Those trends will emerge outside of Asia as well.

The next frontier is the US domestic market

The nascent policy dilemma surrounding all of these issues is what role China's SOEs will seek and be allowed to play in the US domestic market. The US, despite recent economic weakness, still maintains the world's largest and most attractive consumer market. We have robust domestic energy and commodity resources with positive growth prospects, like coal and unconventional hydrocarbons, that present enormous potential profits for the companies involved in extraction. Our open capital markets and regulatory structures underpin and support our attractiveness as an investment destination for foreign firms.

Chinese SOE investment in the US remains nascent. Available data from private research firms shows just $10 billion of cumulative SOE investment into the US market—a paltry sum mostly focused on fossil fuels and financial services. Over the last decade, reputational risk, especially the possibility of running afoul of the Committee on Foreign Investment in the United States (CFIUS), has deterred would-be Chinese investment. Yet many Chinese SOEs, in a wider array of industries, are cash-rich. The goods they produce are becoming globally competitive. These firms will seek opportunities within US borders, and US household and corporate consumers will be interested in their products.

As Chinese SOEs look increasingly to the US market, the US government will face a difficult balancing act between conflicting priorities. On the one hand, very real energy and broader national security concerns are at play—and these concerns have been the principal obstacles for Chinese SOEs seeking investments in the US in the past, as in CNOOC's failed 2005 effort to acquire Unocal. On the other hand, SOE investment into the US economy would bring much-needed new capital and job growth that would have appreciable positive economic—and political—ramifications across the US.

Two broad scenarios are possible. The US and China may find ways to effectively manage Chinese investment into the US. Beijing, for its part, must provide more transparency about the investment, funding, and even accounting practices of China's SOEs. This would help to assuage national security concerns in the US over Chinese investment. In Washington, policymakers must also work to complement the largely depoliticized CFIUS vetting mechanism with more public and high-level political support and perhaps even investment incentives for Chinese firms interested in the US market. The Obama administration will surely seek to provide some such support while China's Vice President Xi Jinping visits the US this week. Of course, coming to full agreement on these terms is impossible, but progress is certainly possible. Such progress would help to entrench bilateral investment as a tangible underpinning of a largely stable US-China relationship.

The other scenario is one in which the flow of Chinese SOE investments into the US remains largely stalled. This scenario would assuage US energy and national security concerns in the near-term. But it would actually aggravate national security concerns over the long run by setting up a structurally more conflicted US/China relationship.

In my view, that would be a mistake. Within its borders the US does and will maintain a position of strength in relation to China's SOEs. Given our robust IPR protection regime and our national-security investment review processes, we have sizable levers to encourage job-generating investment here while protecting our domestic security interests and protecting our own firms from unfair competition or intellectual property theft.

For years, US businesses have been willing to compromise their IPR protection concerns in China, understandably seduced by the promises and potential of the Chinese consumer market. The US government should likewise be able to capitalize on the promises of our own, much larger consumer market to shape the business practices of China's SOEs.

Thank you very much.