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U.S. Investment in China's Capital Markets and Military-Industrial Complex
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I. Introduction

Thank you for inviting me today to speak on this important topic.

I am a specialist in China's domestic political economy, but not necessarily U.S. investment in China, and so my testimony will focus on the changing role of the Chinese state in China's capital markets, and in particular the increasing financial presence of the state outside of what has long been considered the "state sector," meaning firms majority-owned and controlled by arms of the Chinese state. This expansion of state investment is novel in China's political-economic history and quite recent, accelerating especially since 2015. It is, therefore, too early to make confident statements about its effects, but nonetheless several patterns have emerged in terms of sources and logics and these patterns have several important consequences. Let me speak about these origins, means, and potential consequences before turning to U.S. policy.

II. Sources and Means

Based on research I have done with my co-author[1] and my reading of related work in the field, there appear to be three prominent sources of state capital. These sources have somewhat different logics, but are not mutually exclusive.

1) Recent industrial policy, especially Made in China 2025.

China's most recent industrial policy, Made in China 2025, has called for comprehensive upgrading and localization of China's manufacturing capabilities. A primary means of implementing the policy has been the creation of "government industrial guidance funds" (政府产业引导基金, or industry funds) in strategic sectors, such as semiconductors, artificial intelligence, and electric vehicles, among others. Funds are initially supplied by the state at many levels—central ministries, provincial or municipal governments, and so forth—but matched by private funds and managed by private capital management companies. In 2014, the State Council called for the creation of multiple professionally managed private equity funds to make equity investments on behalf of the state, a model Beijing had piloted (with the Ministry of Industry and Information Technology's encouragement) in 2013 with two private firms to serve as managers of the Beijing Integrated Circuit Industry Investment Fund with $1.2 billion in target capital.[2]

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[1] See Hao Chen and Meg Rithmire. "The Rise of the Investor State: State Capital in the Chinese Economy." Studies in Comparative and International Development. September 2020: 257-277.

[2] China State Council, "Guideline for the Promotion of the Development of the National Integrated Circuit Industry", https://members.wto.org/CRNAttachments/2014/SCMQ2/law47.pdf, accessed December 2018; Ministry of Industry and Information Technology, "Public Announcement on Selecting Management Companies for the

To be sure, large-scale state funding for industrial upgrading is not novel in China, but the matching of public and private funds is, as is the large-scale provision of state capital for the private sector. Ding Wenwu, president of the national IC fund, explained: "we separated the ownership and management of the fund. All personnel appointments of the management company follow ordinary market principles and no executive is a government official… But contrary to the private sector, we would also invest in risky projects that may not yield short-term financial returns but hold strategic value."[3] The language of state planning documents makes quite clear that policy-makers intend for the industrial policy to be "market drive, government guided," meaning combining government "steerage" with genuine market mechanisms.[4]

Here it is important to note that tallying the totals of these funds is challenging for a few reasons. First, because the funds exist at many layers of government and are constantly changing, statements like "Beijing is investing x billion dollars in [some sector]" should be met with skepticism. Frequently, it is not "Beijing" but a variety of actors inside and outside the state who co-invest, all with different reasons. Second, the funds are announced as targets meant to signal ultimate amounts. The state contributions are seed funding that "private" or "social" capital is meant to match, so the actual amount of state funding in any given fund is uncertain. Again, confident statements about numbers should be greeted with some skepticism.

That said, the scope of state investment through the industrial guidance funds is enormous. A recent estimate is that the total of central and local funds across all sectors is in excess of 10 trillion RMB, focused predominantly on high tech sectors but distributed widely.[5]

2) State-Owned Capital Investment and Operation

The second source is the expansion of central and local shareholding companies who extend state capital into the non-state sector. The introduction of investment as a function of state capital entails a delegation of authority to firms, both state and private, as managers of state capital that involves significant autonomy. In November 2013, at the Third Plenum of the 18th Party Congress, a Central Committee decision on "comprehensively deepening reform" formally encouraged the establishment of "state-owned capital operation companies" (国有资本运营公司) to shift from "managing enterprises" to "managing capital."[6] In July 2014, the first two official "state capital investment companies" were established under two SASAC-managed

Private Equity for Integrated Circuit Industry Development," (关于北京市集成电路产业发展股权投资基金遴选管理公司的公告) December 18, 2013, http://www.miit.gov.cn/n1146285/n1146352/n3054355/n3057643/n3057649/c3625593/content.html.

3 China Electronics News, "Scoop: Ding Wenwu Interprets the Big Fund (独家：丁文武详解大基金)" October 23, 2017. http://www.sohu.com/a/199698015_464075.

4 Barry Naughton. *The Rise of China's Industrial Policy, 1978-2020*. Universidad Autonoma de Mexico. 2021. pp. 100-101.

5 Naughton 2021, pp. 107-108.

6 State Council. "Decision on Major Problems of Deepening Reform."《中共中央关于全面深化改革若干重大问题的决定》November 15, 2013. http://www.gov.cn/jrzg/2013-11/15/content_2528179.htm.

SOEs, COFCO (a food processing company) and SDIC (an investment holding company).[7] A year later, a state directive on SOE reform explicitly encouraged state capital into private firms: "state-owned capital invests in non-state-owned enterprises in various ways" to "focus in public services, high-tech, eco-environmental protection, and strategic industries… and non-state-owned enterprises with large development prospects and strong growth potential."[8]

That policy document also set a 2020 deadline for "decisive achievements" in SOE reform, requiring SOEs to demonstrate progress in "mixed ownership reform." The deadline may explain why some local SOEs have pursued the purchase of listed, non-state companies: to provide shells for SOEs to enter markets and appear as if they have conducted mixed-ownership reforms. After the promulgation of the policy 2015, the number of listed firms owned by either the central or local state have increased: from 344 to 368 for central firms and from 662 to 700 for local firms (all the while, the number of total firms listed has remained 3682).[9]

In February 2016, two new "state-owned capital operation enterprise" pilots were established within China Chengtong Holdings Group and China Reform Holdings, both asset management holding companies governed by SASAC. Both established multiple funds, with additional shareholders primarily drawn from other SOEs, that provided capital for SOEs to buy listed private firms. By the end of 2018, these two managed total assets of RMB 900 billion.[10] By December 2018, an additional 18 central SOEs were designated to be state-owned capital investment enterprises.[11] A policy document issued in 2018 established implementation guidelines for these types of pilot firms, stating the objectives to include "promoting the rational flow of state-owned capital, optimizing the investment of state-owned capital, concentrating on key industries, key areas and advantageous enterprises" in "good service of national strategy needs."[12] While official language remains vague about the distinction between capital investment and operation, interviews suggest that capital operation firms may take a more active investment stance, perhaps managing distressed assets, while investment firms would handle more passive investments.

3) Ad hoc and local state capital

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[7] State capital investment companies are called 国有资本投资公司 in Chinese. SASAC. "SASAC Held Press Conference on the 'Four Reform.'" 《国务院国资委举办"四项改革"试点新闻发布会》July 15, 2014. http://www.sasac.gov.cn/n2588020/n2588072/n2591426/n2591428/c3731034/content.html

[8] State Council. "Guiding Opinions on Deepening Reform of State-Owned Enterprises."《关于深化国有企业改革的指导意见》September 13, 2015. http://www.gov.cn/zhengce/2015-09/13/content_2930440.htm.

[9] Interestingly, the share of market capitalization owned by the state has stayed relatively steady at both levels, around 24% for the central state and around 19% for the local state. This would mean that the firms that fall under state ownership are not of substantial value. Data collected from WIND.

[10] Li Yifang. 2019 "Increase in A Share Equity Transfer: Reason, Features, and Policy Recommendations." (**A 股股权转让大增的特征、原因及政策建议**). Shanghai Securities Research Report (**上证研报**). Number 8, p. 16. Note that China Chengtong Holdings Group's website lists these partners in the establishment of the group's "China Structural Reform Fund Corporation Limited." http://www.cctgroup.com.cn/cctgroupen/about_us/group_profile/index.html.

[11] We provide a list of these firms in Supporting Information Table 1.

[12] State Council. "State Council suggestions on implementing the pilot program in promoting state-owned capital investment and operating companies." 国务院关于推进国有资本投资运营公司改革试点的实施意见. Document No. 23. July 14, 2018. http://www.gov.cn/zhengce/content/2018-07/30/content_5310497.htm

As the central state has emphasized the need for state capital investment and operation, local governments have joined central shareholding funds and SOEs in pursuing investment in the private sector. Beginning in the second half of 2017—after the establishment of central-level experimental state capital investment and operation enterprises but before the 2018 Document providing official guidance on these firms—local SASACs began to establish state-owned capital investment and operation companies. Local investment companies have, in many cases, gone beyond minority investment, frequently engaging in "ownership transfer" of private, listed firms—essentially nationalization through open market equity purchases.

According to formal reports from the Shanghai and Shenzhen stock exchanges, these kinds of transfers are not large in number, but the trend is a significant one. Since 2016, listed firms have changed their controlling owner from private to state at an average rate of ten per year. This number was as high as 23 firms in 2018. Of all of the listed firms that undergo major ownership reforms, the clear trend in 2017 and 2018 is that most of these firms are private, not state-owned (306 in 2018, double the number of privately-owned firms to undergo equity transfer in 2017).[13] Ultimately, the rate of open-market nationalization appears to exceed privatization in an upending of the connotation of "mixed ownership reform," which has been the emphasis of SOE reform in recent years.

Most examples of private firms falling under state control involve distressed firms or large conglomerate firms under tremendous political and financial pressure. In many cases, firms experiencing a suspension in trading for a significant amount of time are eventually purchased by local SASACs, as was the case with a technology company in Anhui (Changxin Technology) and several others in Fujian in 2018. Those who have welcomed state capital have argued that state investment or ownership helps distressed firms access capital and resources, while others (especially academic economists) have worried that "mixed ownership reform" is inviting state capital into the private sector rather than the other way around. In the cases of large, distressed conglomerate firms, heavy pressure from regulators has forced companies like HNA, Dalian Wanda and Fosun to unwind some of their global purchases; HNA reportedly sold its 7.6% stake in Deutsche Bank to a group comprising a number of state shareholding firms, including CIC and CMIG, profiled below. Some of Anbang Insurance's assets were taken over by local SOEs in Xiamen and Shenzhen after the company was nationalized and its chairman jailed in early 2018.[14]

Yet much of what I would describe as ad hoc state capital entry is not at all into unsuccessful firms and predates the 2015 ballpark I am providing for when the state became a massive shareholder. Recent research in corporate filings and detailed work on shareholding in China's

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[13] Li Yifang. 2019 "Increase in A Share Equity Transfer: Reason, Features, and Policy Recommendations." (**A 股股权转让大增的特征、原因及政策建议**). Shanghai Securities Research Report (上证研报). Number 8, p. 2 and 9.

[14] Chen, Yanqing. 2018. "Entry of local state capital into private enterprises continues: more than 10 private a-share companies will become state-owned this year (地方国资入主民企再掀高潮：今年超 10 家民营 A 股公司将变身国企)", *Tencent News: Finance,* October 9, 2018

largest firms[15] shows that many firms in China who have met success have, at some point, received significant investment from state-connected firms (e.g. SOEs) or state-connected individuals. I describe this as ad hoc because there is no evidence it is coordinated by any planner or policy-maker, and in fact can sometimes be evidence of corruption and malfeasance rather than state strategy.

III. Logics and Intentions

Rather ironically, an economic rationale for extending state capital to the private sector has been to provide a fix to other institutional and economic problems generated by the outsized influence of the state sector. Private firms have been systematically excluded from China's capital markets, leading them to rely on a "shadow banking" ecosystem in which lenders connect to firms beyond the reach of regulators, sometimes using banks as intermediaries but off the balance sheet.[16] China's shadow banking industry has ballooned in recent years, and regulators have sought to combat the "systemic risk" of corporate debt and un- and under-regulated financial products by cracking down on shadow banking platforms and big borrowers. While the crackdown on shadow banking may have reduced associated risks, it nonetheless further restricted financing for non-state firms, ironically prompting the state to **offer itself as financier** to the private sector.[17]

Relatedly, a motivation for state investment has been **industrial upgrading**, which policy-makers have (perhaps correctly) theorized is unlikely to come from firms it has traditionally funded, i.e. state-owned enterprises. New science and technology plans and industrial policy emphasizes frontier technology industries, and the movement of state capital into non-state firms in these sectors a feature of the party-state's distrust of the innovative capabilities of SOEs on the one hand and distrust of the non-state financial sector on the other.

This **distrust of the non-state financial sector** should be understood as a major reason for the extension of state finance and state minority shareholding. Our research shows a massive expansion of state shareholding in 2015 as a result of the efforts of the so-called "national team" to arrest the collapse in asset prices that year. At the height of the state's intervention, state shareholding firms (and principally Central Huijin and CSF) held shares in over half of the firms listed on the Shanghai and Shenzhen exchanges. In 2019, those two funds retained positions in 1,175 firms, about evenly split between private and state-owned firms.[18] The logic here, and in many cases, is about maintaining economic and financial stability—risk management— rather than any long-term strategic planning. Here we see the party-state's intolerance for market discipline, even when that discipline promises to correct distortions and imbalances, such as correction for the bubble that developed in 2014-2015.

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[15] Chong-En Bai, Chang-Tai Hsieh, Zheng Song, and Xin Wang. "Special Deals from Special Investors: The Rise of State-Connected Private Owners in China," Working Paper 2020. https://faculty.chicagobooth.edu/-/media/faculty/chang-tai-hsieh/research/special-deal-special-investors.pdf.

[16] Kinda Hachem. 2018. "Shadow Banking in China." *Annual Review of Financial Economics*. 10: 287-308.

[17] Xiao Gang. "Manage the Pace and Intensity of Risk Management and Promote the Healthy Development of the Asset Management Industry – Report for the 2019 China Wealth Management 50 Forum." Xinhua News, August 20, 2019. http://www.xinhuanet.com/money/2019-08/20/c_1124896522.htm Note: Xiao Gang is the former Chairman of China's Securities Regulatory Commission.

[18] See Chen and Rithmire 2020, p. 267-269.

Overall, we should see state investment and shareholding as a product of the party-state's desire to have a financial system that allocates capital to non-state firms but also its unwillingness to entrust financial allocation to non-state actors. Theoretically, a more transparent financial system subject to market discipline would push capital to productive firms in frontier sectors, but that would require legal developments and a tolerance for financial instability that are incompatible with the party-state's focus on risk management and desire to preserve the status of state firms, financial and non.

IV. Effects

As I stated above, it is too early to say systematic things about the political or economic effects of the expansion of state investment, for example whether firms that have the state as a minority shareholder experience greater access to capital or revenue growth or somehow espouse political views or take actions that show party-state "control" in some way. Instead, let me say a few things about potential consequences.

1) New state "agents" and problems of control. For decades, the scholarly view has been that managers at SOEs have been at least partially disciplined by Beijing because they are appointed by the Organizational Department of the CCP. Clearly, managers at private firms and managers of private capital are not, and therefore it is difficult to see how effective they will be at carrying out the state's strategic goals. Let me be very clear: there is a tendency to assume that a firm that has state capital is an arm of Beijing, and this assumption is incorrect. We know that it has been difficult to manage principal-agent problems in state-owned firms, and has been much more difficult with this new layer of private actors outside the disciplinary hierarchy of the party-state. Examples abound:
    1. Large conglomerate firms with obfuscated state shareholding who, thanks to ballooning debt and sprawling overseas investments, threatened financial instability and were nationalized.[19]
    2. Newly-founded "private" investment companies with state backing, such as China Minsheng Investment Group (中民投), who entered state receivership within a few years because of self-dealing and basic theft of state resources.[20]
    3. Local and national entrants into frontier tech markets who manage to secure extensive state resources for developing semiconductor fabs and are later exposed as fraudulent (Wuhan Hongxin) or existentially overextended (Tsinghua Unigroup).

My point is that the expansion of state capital presents as many complex threats to the state's influence among non-state firms as it does potential extensions of state influence.

2) Enhanced monitoring capacity of the state. The expansion and perceived expansion of "financial risks" in recent years has motivated the party-state to seek

[19] The best examples are Anbang Insurance (entered state receivership in 2018) and HNA, which declared bankruptcy in 2021.

[20] For an extensive discussion of this, see Chen and Rithmire 2020: pp. 269-271.

greater monitoring capacity over non-state firms. Regulatory agencies were surprised in the mid-2010s by the emergence of novel financial platforms and technologies, by the expansion of corporate debt, and by the rapid internationalization of domestic firms, each of which posed unique financial and political stability risks.

V. U.S. Policy

I would like to offer a few observations that, I hope, will be helpful to the commissioners as you consider U.S. policy.

First, it is my observation that American financial firms, especially those who participate extensively in China's A-shares markets under the Qualified Foreign Institutional Investor (QFII) program, are savvy observers of China's markets and the state's mechanisms for intervention. It is not my assessment that they need protection via U.S. policy from the unique political economic features of Chinese markets.

Second, I am not alone in characterizing China's financial policies as opportunistic and experimental.[21] As American policy-makers craft approaches to dealing with China's changing state capital management, I caution them against seeing strategic coordination in everything Chinese funds and firms do. As I have endeavored to clarify, the recent expansion of state capital in China's economy has multiple agents and logics, and the presence of state capital from one or even multiple sources in a firm should not be read as evidence of state control or data from which to glean state intentions.

Third, at least so far, the increasing presence of state capital outside majority state-owned firms is best understood as a pathway for possible state intervention in firm affairs. As the commissioners surely know, the Chinese legal landscape has, in recent years, expanded the state's legal purview for intervention in firms and control over firm assets.[22] We do not yet know how these laws will be enforced, but the potential for consequential state intervention is clearly there. I would read state minority shareholding in the same way, as a pathway for potential influence rather than surefire evidence of state intent and control.

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[21] See, for example, Naughton 2021.

[22] For example, the National Intelligence Law (2017).
http://www.npc.gov.cn/npc/c30834/201806/483221713dac4f31bda7f9d951108912.shtml