April 4, 2006

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Statement before the U.S.-China Economic and Security Review Commission

Hearing on *China's World Trade Compliance: Industrial Subsidies and the Impact on U.S. and World Markets*

Thank you, members of the Commission, for the honor of addressing such a distinguished and thoughtful panel. Industrial subsidies in China derive from governmental dominance of the economy and from various factors including the central, provincial and municipal governments' strategic goals, patronage, and corruption. The subsidies include direct and indirect components that affect both the top and bottom lines of industrial operations. My statement stems from research that I have conducted over the last 7 years on business in China, some of which has been published in my book, The Chinese Tao of Business: the Logic of Successful Business Strategy (John Wiley & Sons). Answers to specific concerns follow.

In what form and in what industries do subsidies exist in China?

State subsidies flow into State-Owned Enterprises (SOEs) although some well-connected private firms also benefit from indirect subsidies such as Special Market Information. In 2002, the state controlled half the industrial output and SOEs still account for 35% of urban employment. Almost all of China's heavy industry and much of its technology lies in governmental hands. The government controls about a third of China's economy through SOEs in key sectors such as defense and utilities. The State Owned Assets Supervision and Administration Committee (SASAC) directly manages the top 190 or so SOEs, the biggest of which have international stock-market listings.

Subsidies exist in all industries that the Chinese state and provincial governments considered economically or militarily strategic, including Resource Extraction, Steel, Computing, Software, R & D, Environmental Services and Conservation, and Autos.
The subsidies exist in various forms, including:

1. Free to Low-cost Loans. The government exercises a vice-like grip on banks, stock markets and bond issuance and these translate to the ability to make grandiose loans. The most extreme statistics in the financial sector deal with loans outstanding. In three years from 2002 to 2004, loans increased by 58 per cent, or $785 billion. In 2003, new lending equaled almost one quarter of gross domestic product (GDP). A credit binge fueled this latest boom. Half of all bank loans go to SOEs. Most of these loans will never be repaid. Huawei for example, has a $10 billion credit line from China Development Bank.

2. Asset Injections: The SOEs' parent companies, usually municipal governments or ministries, provide their protégés with opportunities to acquire state-run businesses, such as toll bridges, at highly preferential terms.
3. No Break-even: Poor bookkeeping practices, and lax bottom-line considerations, grant SOEs freedom from the need to make profits, or to break even.
4. Subsidized Purchases: SOEs can purchase their components and raw materials below cost and directly from each other, affecting the competitiveness of certain sectors in the global economy. This tradition propelled the Chinese motorcycle industry's ability to buy control of virtually all Indian motorcycle companies short of Bajaj and turn them into assemblers of Chinese components.
5. International Bargaining Power: Beijing has used its enormous buying power to intercede for its SOEs with foreign suppliers and to reduce acquisition costs for raw materials. A recent example includes the Chinese government's aborted attempt to bully down the cost of iron ore for the Chinese steel industry below internationally-negotiated price levels. The Chinese government has also secured contracts and exploration rights abroad for its SOEs.
6. Labor Controls: The government exercises various methods to control employees including the *dang'an* or employment dossier; and to reduce labor costs through injection of part-time and migrant workers and the use of prison labor.
7. Tax Breaks: Many SOEs avoid taxation or reduce it through tax breaks (although this can backfire if a company's management loses favor).
8. Energy and Land Subsidies: The state subsidizes gasoline and electricity. Currently, Beijing tightly controls the price of both gasoline and electricity at well below their true economic levels. The state also offers free land and utilities to SOEs and companies in key strategic sectors.
9. Sectoral Credit Allocation: The Chinese economy speeds up or slows down on a sector-by-sector basis on credit allocations by Beijing. Some sectors such as automotive, steel, ethylene and metals' smelting have come off the boil. Others sectors such as coal, railways and utilities are still getting huge infusions of policy-mandated credit. Very high levels of bureaucratic interference characterize credit allocations and industrial-project approvals in China and the state banking system does not allow the market to price capital.
10. Stock Listings: SOEs and Collectives form over 93 percent of the listing of approximately 1300 companies on China's Shanghai and Shenzhen Stock Exchanges. Provincial governments pressure government regulators to discriminate against private companies and give the precious slots to their ailing state dinosaurs. Indeed, private companies without state connections cannot obtain a listing on any Chinese stock exchange
11. Cheap Technology: China runs a deficit on its technology trade with the rest of the world and foreign multinational companies control 80 percent of technological imports and exports in China. The Chinese have made little progress in either basic research or advanced design in vital industries. Despite this institutional flaw, SOEs such as Huawei owe much of their success to lax laws governing the theft of intellectual property.
12. Control over Distribution Channels: Provincial and municipal governments control distribution channels to allocate and to manage market share, to protect favored industries from competition and to shape investment patterns. Regulations on distribution

incorporate considerable ambiguities leading to both legitimate differences in interpretation and considerable legal efforts to find loopholes. Central and provincial governments routinely use this ambiguity to confer privileges on favored companies or industries, and to withhold normal rights from companies or industries as a form of protectionism. Administrative guidance from various and competing sources can override the basic laws or regulations either explicitly or unofficially. Provincial or municipal governments may interfere with the national limits on distribution by their generosity (to lure investment or to meet local goals) or restrictions (to protect local interests). *Guanxi* with local army officials assumes particular importance for distribution. Some estimates suggest that the Peoples' Liberation Army (PLA) controls distribution of goods for up to about 80 percent of the Chinese population. Its control over manufacturing facilities also makes the PLA China's largest and most diversified manufacturer of industrial and consumer goods.

13. Special Market Information: Relevant information for strategic decisions comes at a premium price in China and often includes what we in the USA would consider Insider Information. In China, the central government deliberately controls and disseminates information that it considers of strategic importance. When restrictions on distribution insulate foreign or Chinese companies from their customers, they also cannot undertake direct market research and have to rely on less-sophisticated surrogates. For example, General Motors' (GMs') interns in Beijing have scoured the capital's streets to find out who is buying their cars after the intermediaries get them, so that GM can build *guanxi* with the buyers.

What complications, if any, in evaluating such subsidies are caused by the lack of transparency in China's government and economic systems?

Lack of transparency affects ability to monitor all forms of subsidy except perhaps Stock Listings. Opacity serves as a tax which

1. Reduces ability to determine the true efficiency and productivity of China's labor and results in potentially sub-optimal foreign direct investment (FDI) decisions until after commitments are made. Consequently, our research has shown that FDI enjoys higher ROIs and ROEs across entire industrial sectors in India against China, including Capital Goods; Food Beverage and Tobacco; Materials; Pharmaceuticals and Biotech; and, Software and Services.
2. Reduces the ability of US domestic producers to prove dumping, especially as so many of those affected are Small and Medium-sized Enterprises with limited resources.
3. Magnifies the weakness of China's statistical system which depends too much on reporting and too little on sampling; the statistical system shows a systematic bias to over-report growth at the bottom of the economic cycle and under-report it at the top, i.e. to flatten out a much more volatile economic cycle. Recently, some foreign companies have started constructing their own physical-activity indices of everything from freight-barge traffic to power consumption and air miles flown to find true economic indicators, but the enormous expense constrains companies from doing this well.
4. Reduces the credibility of the SOEs' books. For example, in 2003, China's top 500 SOEs reported revenues of 4.07 trillion Yuan up 25 percent from the previous year; and profits

of 334 billion yuan, up 33 percent from the previous year. Only 87 of the 500 reported making losses. Unfortunately, outright fraud aside, most SOEs' managers do not know their real profits and tell their supervisors what they want to hear

Unreliability in macroeconomic data also seriously compounds the problem of estimating the effects of subsidies.

- For example, in February 2002, the Chinese government said that China's GDP had grown by 7.3 percent in 2001, making it the world's fastest-growing economy. However, growth rates reported by individual provinces told another story. Only one, Yunnan, said its product had grown slower than the national rate. Taken together, the provincial figures produced a national growth rate nearly two points higher than the official rate! The National Statistics Bureau (NSB) conducts sample surveys and uses these to estimate the country's GDP and growth rate. The results have invariably disagreed with provincial figures. In 1995, the GDP growth rate suggested by provincial data averaged three percentage points higher than the figure of 10.5 percent produced by sample surveys. Opinions vary as regards the accuracy of the central government's estimates. However, in China, few scholars publicly attempt any detailed justification of alternative figures because of political sensitivity.
- China's NSB also lacks the capacity to collect data outside normal information channels and lower-level officials interfere with its surveys. The numbers generated by provincial governments remain an important criterion in evaluating local officials' performance, creating an incentive for statistical falsification. The pressure to exaggerate statistics grew in the late 1990s as Chinese officials sought to pump up the economy to stave off the Asian economic slump's effects. Beijing declared that the country had to grow at least 7 percent a year to create jobs and to forestall social unrest. Not surprisingly, reported growth rates have not dipped below that level since.
- Officials may also routinely underreport other sensitive data such as debt numbers, unemployment or even FDI to avoid tax payments and governmental scrutiny. The central government's methods at ascertaining the validity of data, a process it calls *yasuo shuifen* or "squeezing the water", involves sample surveys, price-index adjustments and plenty of guesswork.
- Technical difficulties, such as staff reductions among statistical analysts, have enhanced errors in data. No comprehensive measures exist for the size of the fast-growing private-business and service sectors or even for what constitutes FDI.
- The Chinese government strictly controls economic and industrial data and even classifies some as state secrets. Routinely, Beijing has overvalued SOEs' stocks of unsold goods, and underestimated inflation. Other provinces underreport growth and activity: for example, Zhegiang province in Eastern China may have underreported growth to conceal the rapid development of private companies in its economy. Additionally, affluent provinces, such as Guangdong in Southern China, may have underreported growth to avoid paying more taxes to the central government. However, without more systematic data, economists cannot definitively state if these factors pushed up growth or even occurred.

- Governmental officials downplay unemployment figures to mask the suffering that economic reforms and restructuring have caused. The official unemployment rate of 3.6 percent in 2001 excluded *xiagang* workers (laborers receiving small, monthly stipends from former companies and not counted as unemployed) that economists estimate to number about 10 million. The official rate also excluded farmers who left their fields to work in cities, a floating population of around 150 million unemployed migrants. Using international standards, China's unemployment rate in 2001 approximated 7.6 percent in rural areas and more than 8.5 percent in the cities, well above Beijing's red-flagged figure to indicate inevitable social turmoil.
- Most disturbingly, the central government's debt numbers look highly erroneous. The Central Bank's governor, Dai Xianlong, confessed to Parliament in April 2002 that national domestic debt appeared much higher than the official numbers (16 percent of GDP) suggested. Dai said the figure appeared closer to 60 percent of GDP if one considered unfunded state-pensions' liabilities, local governments' debts, and major banks' nonperforming loans (NPLs). Dai's unusual candor may mask more bad news. Independent economists have discovered that Dai's statistics drew on China's yearbook GDP growth statistics. Debt more realistically appears closer to 100 or 125 percent of GDP. The Bank of China reported two different figures for its NPLs in 1999, one using Chinese accounting standards, another Western; the latter looms 2.6 times greater than the former. Moody's has openly called the books of China's "Big Four" banks, "meaningless"

What subsidies will be utilized for the 11 th Five-Year Program Period?

I anticipate that all the subsidies that I identified will continue. The 11 th 5-year plan specifically identifies certain strategically important industries that will receive state subsidies. These include

1. Integrated circuits and software including technology for 90-nanometer and smaller integrated circuits
2. New-generation networks including digital TV networks and mobile communication
3. Advanced computing including technology for petaflop computer systems
4. Biomedicine including commercial production of vaccines
5. Civil airplane including general purpose planes and helicopters
6. Satellite applications including meteorological, oceanographic, navigation positioning and telecommunication satellites
7. New materials including high-performance materials in information biological and aerospace industries

Researchers may have more difficulties monitoring the rate of subsidization as China's 11 th Five-Year Plan has only two numeric targets: per capita GDP in 2010 must be double the 2000 figure and "each work unit must cut its use of energy by 20 percent of current levels by 2010". The plan fails to mention raising the price of electricity and gasoline, and unlike the previous ten years, sets no economic growth targets.

How pervasive are subsidies in China?

Our research has shown that despite recent deregulation efforts, state consumption through its SOEs dominates the Chinese economy. Figure 1 indicates difference in state domination of the Indian and Chinese economies. Subsidies permeate SOEs and well-connected private companies but do not extend to the bulk of private companies.

The subsidies appear huge. According to a World Bank study, 51 percent of all SOEs are losing money. Average current assets had risen to 319 days of annual sales, suggesting that most of the SOEs' assets lay in uncollectible bills or unsaleable inventory. In short, most SOEs were illiquid and massive injections of government money kept them alive.

Are they specific to certain industries, or are they broadly available?

The state offers subsidies to specific sectors and across sectors. Generally, SOEs and well-connected private companies with strong government network connections can access subsidies. The state is more likely to offer subsidies to private companies that promote strategic development efforts. The 11 th Five-Year Plan identifies the following foci for development:

1. Advanced computing.
2. Internet.
3. Programming.
4. Environmental services & resource conservation.
5. Energy production and reserves.
6. Value-chain positioning of Chinese manufacturing.
7. Space, satellite and space-launch related capabilities.

What policies underlie the subsidies? Are they primarily targeted at companies that export or are they available to companies that serve the domestic market?

The state grants subsidies to companies that export as well as to those that serve the domestic markets. Political rather than primarily economic considerations guide policies on subsidies. For example, many provincial governments offer subsidies as rewards to those that successfully manipulate government and business networks.

SOE reforms and strategic goals also shape policies on subsidies. However, for China's leadership, SOE reforms do not include concerns about profits or privatization. The reforms do not have as their goal reducing the state's control over key sectors of the economy, but rather making that control more effective. Consequently, the policies aim to make SOEs efficient and big enough to have a strong international presence such as the foreign multinational companies do. Specifically, the Chinese government wants its own global stars. The SASAC, which oversees SOEs, has the mandate to transform 30-50 SOEs into globally competitive national champions by 2010. These include PetroChina, ChinaMobile, Sinopec, CNOOC, Baosteel, China Aluminum, Shanghai Auto, Lenovo, TCL, and Quingdao Haier. Korea's chaebol, rather than Japan's keiretsu provide the guiding model for China's policy on industrial subsidies: through subsidies, the state helps the national champions to diversify their range of businesses and to link more closely to the state.

Some of the policies on subsidies stem from long and mid-range strategic plans; others derive from emergent planning and mistakes. For example, responding to the massive NPLs accumulated by Chinese banks in the 1990s, the government ordered they reduce their NPL ratios - bad loans as a proportion of total loans. However, this policy had unintended consequences. China's banks are technically insolvent but enjoy high liquidity. To cut NPL ratios, the banks merely increased the denominator of the ratios: their loans. Lending rose rapidly, driving growth as a side effect as NPL ratios fell from 28 per cent in 2002 to 13.2 percent at the end of 2004. Assisting the process were transfers of old NPLs, made before the recent credit drive, to newly minted asset management companies (AMCs). The largest banks shifted an initial $169 billion in 1999-2000 and another $50 billion last year. The AMCs have become dumping grounds not just for commercial banks' NPLs but also for the assets of failed investment conglomerates, securities businesses and government-infrastructure projects. The state makes the AMCs issue interest-bearing bonds for which it refuses to accept explicit liability. Separately, Beijing has raided tens of billions of dollars of foreign exchange reserves to shore up banks' capital.

Policies regarding subsidies become difficult to unravel as the Chinese state encompasses central and local governments, with competing and often conflicting agendas, and different bureaucratic and political factions at the national level. Subsidies and the policies behind them reflect this fragmentation and conflict. Thousands of warring units that cohabit under the umbrella of the Chinese state control the SOEs. Consequently, SOEs enjoy direct subsidies stemming from state directives and elicit varying degrees of support.

AVIC, the national aerospace group, provides a good example of subsides to an SOE serving a domestic market. Urged by Deng Xiaoping in 1985, AVIC had designed a civil airliner from scratch in less than 5 years. However, it only built two planes and even China's nationalized airlines refused to buy them. Two decades later, AVIC has received several tax breaks to build a small regional jet but has no idea of its commercial prospects

Generally, despite stated policies, outsiders cannot ascertain the true policies that underlie subsidies. A secretive and authoritarian organization with unclear aims, closed to scrutiny and debate, controls the Chinese state. More effectively placed subsidies appear in the SOEs that the Beijing central government has classified as global champions. However, recent examples illustrate their complexity. CNOOC, whose $19 billion bid for Unocal touched off volcanic reactions, is a Hong Kong-listed firm 70 per cent owned by an unlisted parent company, all of whose shares are owned by the central government agency, SASAC. Beijing has helped CNOOC to acquire contracts to control foreign-energy reserves and the company heavily relies on subsidized finance from SASAC. Local governments control other SOEs. These include white goods maker Haier (owned by the Qingdao city government), which launched an unsuccessful bid for Maytag, and the municipally owned Shanghai and Nanjing car companies that have spent the last several months picking through MG Rover. These companies also receive subsidies in line with Beijing's stated goals of creating state-owned multinationals and retaining domestic control over key sectors, such as car making. The demands of both the central government, which sets industry policy, and their local government overlords, whose interests may conflict with Beijing's industrial-policy goals, shape the subsidies the SOEs receive, as well as the SOEs' evolution, strategies and policies. Huawei, a maker of telecoms-network equipment, illustrates a third level of policies and subsidies. Huawei is ostensibly privately owned, although many of its shares are owned by the local state telecoms authorities to whom it has sold equipment. It enjoys a $10 billion low-interest credit line from the China Development Bank, whose mission is to make concessional loans in support of the state's policy goals. Huawei also has strong ties to China's military.

How profitable are companies that serve the China market?
Few multinational corporations disclose the real performance of their Chinese operations. Most estimates have relied instead on business surveys and anecdotes. Our research reveals that only about one-third of the foreign companies operating in China have ever made a profit there, and profits have been concentrated in the hands of a few companies. In addition, historically, foreign affiliates in China have lower profit margins than their global average.
In 1998, a survey of 229 foreign-invested companies by management consultants A. T. Kearney showed that only 38 percent of all manufacturers were covering their operating costs. If the companies had included their borrowing costs, or costs of capital, fewer still could have claimed to have broken even.

Another study done at the Chinese Academy of International Trade and Economic Cooperation showed that about one-third of the 354,000 foreign companies operating in China in 2001 turned a profit. Yet, a 1999 survey by the American Chamber of Commerce in China showed that, while 58 percent of its member companies had lower profit margins there than in other global operations, 88 percent had plans to expand. Deloitte & Touche's survey in 2002 confirmed that 90 percent of foreign-owned companies in China planned to expand their operations within the next three years. In 2003, about 424,196 foreign companies, big and small, operated in China (MOFTEC). Michael Furst, Executive Director of the American Chamber of Commerce, Beijing, informed us that about two-thirds of its member companies were making some profits but not up to anticipated levels, while about one-third were making losses. These figures correspond to those from 2004.

A 2004 survey by China Economic Quarterly shows that the earnings of US affiliates in China, which includes the affiliates' profits, and earnings booked through Hong Kong and Singapore, rose to $4.4 billion. When all other sources of profit are added – including royalty and licensing fees and income from private services – these affiliates earned $8.2 billion in 2004. However, US companies made $7.1 billion in Australia, a market of only 19 million. They earned $8.9 billion in Taiwan and South Korea, emerging economies with a combined population of 70 million and earned $14.3 billion in Mexico. Most respondents could not achieve profit margins above their global average.

A large proportion of the earnings end up with a small number of foreign companies that enjoy lucky breaks in China's heavily regulated operating environment. For example, Mobile Telecommunications encountered no vested interests in China and contributed about half of the US companies' mainland-reported earnings as recently as 2001. However, from 2002, Chinese companies, subsidized by the state, moved into mobile handsets and their cutthroat pricing destroyed profits in that sector.

More recently, a consumer loan boom financed by state-run banks underwrote an explosion in car sales that dropped later like a brick -- but Volkswagen, the market leader, still earned $1.2 billion in China in 2003.

Five US companies, including three car makers, accounted for one third of equity profits that mainland affiliates reported. General Motors alone booked $437 million in earnings. Fast-food companies Yum Brands - owner of KFC - and McDonald's topped off the list. Fast-food companies have consistently made profits in the Chinese domestic economy. They face no competition from state interests and, as services, are less prone to intellectual property abuses. Yum Brands, which has 1,200 restaurants in China, and McDonald's, probably earned about $200 million and the US car companies in excess of $500m - equivalent to about one-third of mainland equity income of $2.4 billion. These figures underline how small China's domestic markets may be.

The exaggerated economic data can have significant effects on perceived performance and projected performance of FDI in China. The successful companies in our research did not rely on economic and industrial data. As Elmar Stachels, Managing Director of Bayer China Company, Ltd., told us “You manage by objectives, objectives that must be clearly stated – then determine what kind of tools you can use to determine if you achieved them, but stick with your objectives. However if it comes to financial figures, it will be challenging. What good will numbers be if the base rates used for comparison of performance are not reliable.”

China remains embroiled in overcapacity and excess production as state investment and subsidies move across sectors, and companies’ profits correspondingly whipsaw. A year ago in the auto sector, sales growth for many car models dropped from three digits to less than zero in a few months. In steel, China flipped from a massive net importer to a net exporter in less than a year. In the past nine months, the global price of ethylene – a base constituent of plastics – dropped by half as Chinese production capacity expanded 35 per cent this year and will probably double in the next few years. Soon, smelted copper will join the ranks: China has 2.5 million tons of annual production capacity and another 2.5 million tons under construction. Similarly, in stainless steel, China's annual production capacity approximated 2.5 million tons at the end of 2004. Industrial projects and subsidies will expand this to 10 million tons in five years.

Thank you again for having me, and I look forward to your questions.

Figure 1
Ratio of Private to Government Consumption