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Hearing on US-China Economic Challenges
U.S.-Chinese State-Owned Enterprises and Non-Market Economics – Competitive Challenges

Chairman Shea, hearing co-chairs Wessel and Slane, commission members, staff, and other distinguished guests, good afternoon, and thank you for the invitation to speak with you today. The role that state-owned enterprises (SOEs) play in the Chinese economy is a complex one, and I must admit my thinking on the whole question is constantly evolving.

State directed capitalism is not a new idea. Many economies have used it at particular stages of their economic development. We saw it in Japan, Taiwan, South Korea, Singapore, to name a few. Most emerging economies give a larger role to the state than developed economies. *The Economist* pointed out that two-thirds of emerging market firms that made it onto the Fortune 500 list are state-owned.

During the decades following World War II and the Korean War, we turned a blind eye towards the deleterious effects of state-sponsored competition on American industry, I think for geopolitical reasons. Not until 1980s Japan did we start to fear the competitive threat to American firms. But China is different both because of its size and the timing. Here is a nation that is challenging the United States in market scale and scope, and its state-funded firms could have enormous global impact.

Among the questions before the commission are statements issued by the Third Plenum last November on the future role of SOEs in the Chinese economy. On the one hand the Plenum reserved a strong and continuing role for SOEs, while also vowing to subject the SOEs to a competitive Chinese private economy. What's that about?

I believe we are witnessing the evolution of a hybrid form of capitalism, what my colleague at HBS Aldo Musacchio describes as state support disciplined by the market. This is not the traditional flavor of state capitalism. These firms are not government departments, they have to compete in the marketplace. They are advantaged because they have access to low cost and patient capital, they can benefit from the structuring of Chinese domestic markets, and most importantly they can invest for the long term. The other form we see is support of private

Chinese firms by state controlled banks, enabling them to do things that would otherwise be out of reach.

A colleague of mine, a young Chinese manager on assignment in the United States with a major multinational, had a great description of how China works. She said that the Chinese "renovate ideas" to make them fit their own needs. "Just look at Buddhism," she told me. I think they are "renovating" Western capitalism to fit their needs.

What role will SOE's have in the implementation of Chinese industrial policy? At the highest level, I believe China wants to control its own destiny, as any country would. In sectors where China is or will become the world's largest market, I think the Chinese government feels entitled to use that market power to set global standards, much as the U.S. has done historically albeit not quite so deliberately. Let me give you an example. China Mobile is an SOE with the largest subscriber base in the world. Its investment in TD-LTE, one of the two variants of the 4G LTE standard, as directed by the government, will favor firms like Huawei and ZTE. It will also benefit Spreadtrum Communications, a Shanghai-based and formerly U.S.-listed mobile chip supplier recently acquired by Tsinghua Holdings, a state-owned company funded by Tsinghua University.

China is the world's largest market for mobile and smart phones, and it is where most of the handsets in the world are assembled. The Chinese government tried to set a new global standard with TD-CDMA but they were too late on that one, GSM was already well established. I think they will be far more successful with TD-LTE. They have the largest market to practice in. Remember the U.S. and Europe are by and large using FD-LTE. I think it is a safe assumption that there is no way China wants to be dependent on U.S. firms like Qualcomm or Cisco for core technology over the long term. Especially post Mr. Snowden, or that will certainly be one of their justifications. Is Huawei a national champion? Yes. Are ZTE, Spreadtrum, and others far behind? They're coming. And many others.

In what other industries does China chafe under foreign dominance? Commercial aerospace, for example. Asia is already the world's largest air travel market, and if you look at China's investments in air transportation infrastructure, or Boeing and Airbus's market growth projections, that is where a lot of the action globally will be. That's why the Commercial Aircraft Corporation of China (Comac), another SOE, is building the C919 to compete in the narrowbody market. Will it take them a while? Sure. Do they have the capital, the patience, the investment horizon to do this? There is no doubt in my mind.

Another set of circumstances drive SOEs like China National Offshore Oil Corporation (CNOOC) or China Petroleum and Chemical Company (Sinopec) – a desire to establish secure bases of supply in a volatile world. Look at CNOOC's attempted purchase of Unocal in 2005, or their more recent acquisition of Nexen in Canada. If I were sitting in a Chinese government office, trust me, I would be thinking this way. It probably even spills over into the thinking of firms like Shuanghui Group when they acquired Smithfield Foods. Now Shuanghui is not an SOE, but they formerly were one. But that's what I think the mentality is – secure my supply base.

And then there is the acquisition of technology. Chinese SOEs as well as private firms realize that they need to acquire technology to build up their capabilities. Sany Heavy Industries Co.

acquired Putzmeister, a German world leader in concrete pumping equipment. Zhejiang Geely Holding Group acquired Volvo for its capabilities as well. Wanxiang Group purchased a great bundle of technologies when it acquired A123. But it's hard to argue with these private company transactions. It's no different than when Cisco buys someone for its technology.

Four-fifths of the such acquisitions by dollar value are by SOEs, or financed by the state-controlled banking sector, according to the *New York Times*. With China holding $3 trillion in assets, why wouldn't you buy all the critical technology you could get your hands on? If I were them, that's what I would do.

Are these all part of China's "go-out" strategy? I would call it a responsible investment strategy. Will that mean more competition for U.S. based multinationals? Yes, of course, it's competition to acquire the choicest assets. What makes this issue so difficult? Some parts of the game they are playing by our rules, some parts of the game they have their own rule book.

Do Chinese SOEs operating in world markets source locally or do they source from China as a matter of government policy? With all due respect, I think that's the wrong question. I can only comment based on what I have observed about Huawei and Lenovo. Both have shown a strong propensity towards vertical integration, doing things themselves. It has served them well. They obviously need to source the best raw materials and components from the best suppliers to stay competitive, but they have demonstrated both the will and the ability to do things internally, in contrast to many American firms who favor vertical specialization and outsourcing.

What are the implications for the United States if China is granted market economy status within the WTO? This is a definitional problem. China and we have different definitions of what constitutes a market economy. We think a free-market free of interventionist distortions. China has their model of state-directed capitalism. I think this asymmetry in definition lies at the heart of our uneasiness, because I believe the spirit of the WTO rules are more aligned with our view. We can argue that they need to play by our rules. When we were the world's "most attractive" market we could make the rules and try to enforce them through market access. That's not necessarily going to change their thinking, in my opinion.

Nonetheless, I see opportunity in the Trans-Pacific Partnership to set the bar for state intervention. We will have to be careful, as Singapore, one of the TPP's founding members, still engages in a lot of developmental subsidies. But to me this is an opportunity to establish some rules of the road prior to a possible entry by China some day.

My most urgent message is to U.S. multinationals faced with competing with Chinese SOEs or private firms with access to state aid or state-controlled bank capital. These firms are aggressive, they think globally, and they have long investment horizons.

We need to learn from history, and not delude ourselves into thinking that because they are not playing fair or because they are playing by a different set of rules, that in the end fair play and justice will prevail. For perhaps the first two decades of Airbus's existence, Boeing complained bitterly about state subsidies, or believed that Airbus would collapse under the weight of competing national agendas. Certainly in the early days of the A300 "white tails," it seemed that state subsidies and launch aid were all that kept them going, so I certainly understood Boeing's point of view. But Airbus kept introducing innovative products, like the NASA developed fly-by-wire and winglets on the A320, and they developed a low cost production system. Constantly blaming state aid or discounting Airbus's capability growth got in the way of Boeing recognizing their own competitive shortcomings, something that they paid dearly for over subsequent years. Cisco take note.

We cannot let the Chinese form of state capitalism distract ourselves from leading the world in innovation, investing for the long term, and ensuring our own global competitiveness. I hope and pray that our leaders here in Washington can think carefully about the shackles and disadvantages we place on *our* firms in this high stakes competition of economic systems.